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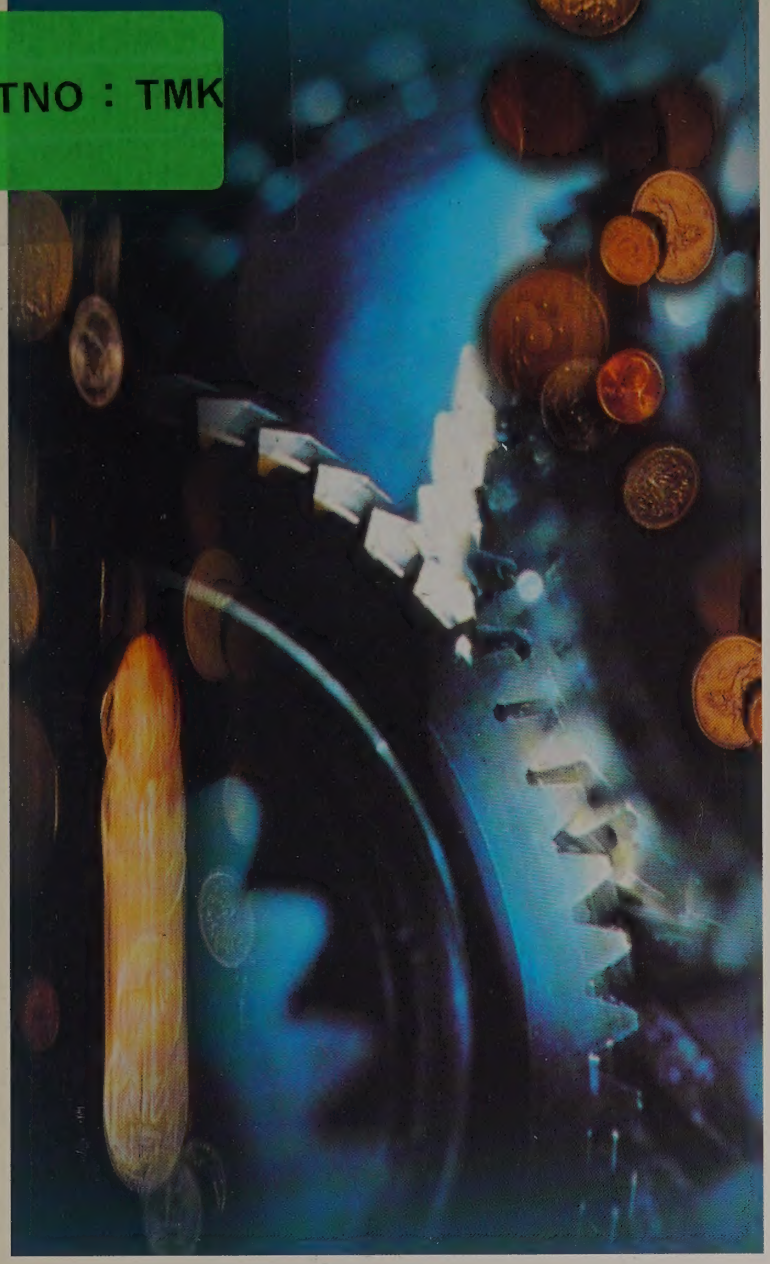

Private Opportunity, Public Benefit

Progressing the Private Finance Initiative

HM Treasury

Private Finance Panel

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FOREWORD

Two years ago I wrote the foreword of a booklet called *Breaking New Ground*. That booklet explained the benefits of the Private Finance Initiative and highlighted where early progress had been made. Since then the new ground has proved fertile. There is now an abundant crop of projects. Some of them - in fields ranging from transport and infrastructure to healthcare and information technology - are profiled in these pages.

These are real, practical case-histories. There was always a solid economic policy to this initiative. The straightforward principles behind it are that the taxpayer should have value for money and that risk should be placed with those best able to manage it. But if anyone could predict every application of a profound change to the culture of government procurement, then we wouldn't need an initiative which had at its heart the rational management of *risk*.

As the number of projects mounts some common principles do emerge. The Government's understanding of what the initiative can do has expanded. Equally importantly, the market is becoming innovative. We hope this guidance will contribute to that process of cross-fertilisation.

This document is as rigorous and concise as we can make it. It is a working handbook, and we expect it to be well-thumbed. But, no, it is not the last word in spelling out every dot and comma of how to proceed with a private finance project. We are not in the business of last words: our motto is "projects, not rules."

Every project is different. Innovation and diversity are the very qualities that will flourish when the private sector is freed to do the work it does best, with the incentive of its own money at stake. The state's role is to be clear on what it wants for the public benefit. As for the role of the private sector, there is a famous saying, "Give us the tools and we'll get on with the job". Today's private sector brings its own tools. The message is: "Give us the opportunity." That we have done and are continuing to do. We are heading towards our target of £5 billion capital value of new projects in the financial year 1995-96. If you want practical assistance in making the most of that opportunity for the good of us all, read on.

Kenneth Clarke

Chancellor of the Exchequer
November 1995

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Chapter 1

Introduction: The Purpose Of The PFI

1.1 The Private Finance Initiative (PFI) has come a long way since its launch in November 1992, and the publication a year later of "Breaking New Ground". This new publication draws together the lessons of experience so far. It describes some of the key PFI projects that have gone ahead, and the lessons which can be learned from them. It incorporates and, in some cases, expands upon the guidance documents issued by the Treasury over that period. It also seeks to provide practical assistance to public sector managers, potential private sector partners and professional advisers on the structure and management of PFI projects.

1.2 **The PFI has become one of the Government's main instruments for delivering higher quality and more cost-effective public services. Its aim is to bring the private sector more directly into the provision of public services, with the public sector as an enabler and, where appropriate, guardian of the interests of the users and customers of public services. It is not simply about the financing of capital investment in services, but about exploiting the full range of private sector management, commercial and creative skills.**

1.3 The PFI has been applied to a wide range of assets and services such as buildings, transport infrastructure, information systems, vehicles and equipment.

Types of PFI projects

1.4 *"Breaking New Ground"* identified three types of PFI project:

- **Financially free-standing projects,** where the private sector undertakes the project on the basis that costs will be recovered entirely through charges for services to the final (generally private sector) user. Public sector involvement is limited to enabling the project to go ahead, for example by undertaking some of the initial planning, licensing, awarding works concessions, providing ancillary works or assisting with statutory procedures. Examples of such projects include tolled bridges and the provision (and operation) of visitor centres at sites of public interest;

- **Services sold to the public sector,** where the cost of the project is met wholly or mainly by charges from the private sector service provider to the public sector body which let the contract. Examples include privately financed prisons and trains for the Northern Line, both described in Chapter 4. A subset of such projects is leases where the bulk of the payments by the public sector to the lessor are for the use of the capital asset rather than buying associated services. However, finance leases will not be PFI projects. The PFI is expected to lead to more private sector involvement in the operation of assets, since many of the value for money gains

in PFI projects come from the benefits of combining asset design, construction and operation;

- **Joint ventures,** where the cost of the project is met partly from public funds and partly from other sources of income, with overall control of the project resting with the private sector. Often the public sector contribution is made to secure wider social benefits that cannot be captured in commercial revenue, such as reduced road congestion. Examples of joint ventures include the proposed Channel Tunnel Rail Link, Croydon Tramlink and various urban regeneration schemes. Detailed guidance on joint ventures is given in Annex A.

Wider policy context of PFI

1.5 The PFI is one of a range of Government policies designed to increase the involvement of the private sector in the provision of public services, or of services that were once publicly provided. Other policies with a similar aim are privatisation and contracting out. It differs from privatisation in that the public sector retains a substantial role in PFI projects, either as the main purchaser of the services provided or as an essential enabler of the project. It differs from contracting out in that the private sector is involved as a provider of the capital asset as well as a provider of services.

1.6 All three policies represent a fundamental change in the focus of the public sector, away from being a direct provider of services to the public and towards becoming a procurer of services and a regulator. The logic of this transformation is to allow both private and public sectors to concentrate on doing what they are likely to do best. Better management results in better value for money. The provision of goods and services is the core business of the private sector. Its incentives where coupled with competitive pressures should ensure the most cost effective outcome.

1.7 Freed from the need to engage in such activities, the public sector can concentrate its efforts for those areas where it can make its biggest contribution. They will include:

- establishing the framework of policies and legislation within which the private sector operates;
- deciding what range of services should be provided from public funds and clearly defining the requirements;
- procuring these services and managing the contracts awarded;
- continuing to provide those services which for policy reasons the Government considers need to remain in the public sector, for example front-line defence.

Benefits of PFI

1.8 **The PFI offers benefits to both public and private sectors. For the public sector, and for the public in general, its primary benefit is more and better projects and better services. These services should also cost less than if provided by traditional public sector means because the private sector achieves efficiences in delivery by better design and management.**

1.9 The PFI secures better projects and better value for money through:

- **Better allocation of risk.** This is central to the PFI. The basic principle of allocating risk to

GENERATION OF ADDITIONAL REVENUE BY SALES TO THIRD PARTIES

Opportunities to generate additional revenue from schemes primarily designed to provide services for the public sector include:

- sale of capacity which is at least temporarily surplus to requirements, for example from a computer or telecommunications system;
- commercial development of land or buildings surplus to the requirements of the public sector;
- sale of software or designs originally developed for use by the public sector;
- using skills developed or experience obtained in serving the public sector to provide similar services elsewhere. For example the ability to meet the high security standards required by some public sector customers might be saleable in other markets.

those best placed to manage it leads to more consideration and better control of project risk at the outset (see Chapter 3 for a fuller discussion of risk transfer). With traditional public sector procurement risk analysis is often weak, and risks only become apparent after the event;

- **Better incentives to perform.** The transfer of risk improves management incentives. Under PFI, payment to the private sector contractor only starts when a satisfactory flow of services is provided and ongoing payments depend on meeting performance criteria. With traditional asset procurement routes, those responsible for creating and purchasing the asset, both in the private and public sectors, may not have direct responsibility for the actual service. They may face pressures and incentives quite different from those of the service provider;
- **Close integration of service needs with design and construction.** A project structure which gives the service provider responsibility for design and asset creation as well as operation;
- **A clearer focus on the respective responsibilities** of public and private sectors which more clearly reflects the strengths of each. The public sector can concentrate on what service should be provided, leaving the private sector to consider how it can best be done;
- **A continuing commercial incentive** for efficiency throughout the design, asset creation and operation of the project;
- **More potential for efficiencies,** and for shared experience, by the provision of assets supplying a wider range of customers (see box above).

1.10 The PFI leads to new investment opportunities. This is clearly the case with financially free-standing projects or with joint ventures in which the private sector is only looking for a limited input of public funds. In such cases projects may go forward which would not have occurred had they been mainly dependent on public funds.

1.11 Projects involving the sale of services to the public sector still have to be paid for out of public funds. Nevertheless, because they involve a smoother flow of payments over the project life, projects may go ahead under the PFI earlier than they would if conventionally funded. The issues of additionality and affordability are dealt with more fully in Chapter 3.

1.12 More generally, the PFI leads to overall cost effective procurement because risk is better managed. The taxpayer's pound should go further.

PFI TERMINOLOGY

The following abbreviations are frequently used in connection with PFI schemes:

DBFO: Design, Build, Finance and Operate

DCMF: Design, Construct, Manage and Finance

BOO: Build, Own and Operate

BOOT: Build, Own, Operate and Transfer

Apart from the important distinction between BOO and BOOT schemes, which depends on whether the asset is or is not transferred from the private sector supplier to the public sector customer at the end of the contract, all these abbreviations, confusingly, have the same meaning. In all cases the private sector supplier has responsibility for designing, building/constructing, managing, operating and financing. Projects described as DBFO may or may not involve transfer of the asset to the public sector at the end of the contract. The term DCMF is normally used for PFI prison projects and involves asset transfer.

The term **"supplier"** is used throughout this publication to denote the private sector organisation (which may be a single entity or a consortium) which masterminds the design, construction/build, finance, and subsequent provision of a service, and signs any necessary contract with the public sector customer.

1.13 The PFI benefits the private sector by opening up a range of additional business opportunities. In many cases, the private sector is taking over the day-to-day management of service delivery in areas like prisons, which have in the past been the preserve of the public sector. In others, for example constructing buildings and then providing them with a facilities management service, PFI projects combine work that has normally been offered only in separate contracts. Single integrated contracts provide opportunities for efficiency savings, the benefits of which can be shared between contractor and customer. The risk transfer involved in PFI projects also offers more scope for higher profits if the risk is well managed, and so rewards increased efficiency.

When to consider PFI?

1.14 Public sector bodies should consider PFI options in each of the following circumstances:

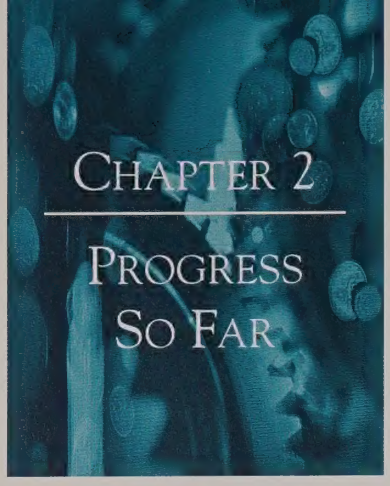
- as part of the prior options exercise when the future of an executive agency or other public body is being considered. The use of PFI should be considered, after abolition and privatisation, and alongside contracting out;
- in the formulation of business strategies and annual efficiency plans;
- when the acquisition of a new capital asset or the replacement of an existing one is being actively considered **or is foreseen.**

Public sector bodies covered by this guidance

1.15 Except where otherwise indicated, the guidance in this document applies to all parts of the public sector including government departments and agencies, non-departmental public bodies, the national health service (NHS), local authorities and public corporations. References to the public sector or to public bodies should be interpreted accordingly.

Other guidance

1.16 This publication provides general guidance on the PFI. More specific guidance on the application of the initiative to particular areas of the public sector, such as the NHS, or to particular procurement areas, for example IS/IT and accommodation, is also available. A full list of guidance is given on page 66.



Chapter 2

Progress So Far

Developments in the 1980s

2.1 By the beginning of the 1980s, interest in the use of private finance to fund investments by public sector bodies, particularly nationalised industries, was sufficiently strong to prompt a re-examination of Government policy. The Treasury set up a committee under Sir William Ryrie which reported in 1981. Its principal conclusions, known as the "Ryrie Rules", were that the use of private funding should be governed by two basic principles:

- privately funded solutions must be tested against publicly funded alternatives and shown to be more cost-effective;
- unless Ministers decided otherwise in particular cases, privately funded projects should not be additional to public expenditure provision, ie. provision for public expenditure would be reduced by the amount of private funding obtained.

2.2 The Ryrie Rules formally continued to apply until 1989 though they were regularly criticised for being too restrictive and giving public bodies no incentive to seek privately funded solutions. Nevertheless there were some projects initiated in the 1980s using private funding. A concession to design, build, finance and operate a third crossing of the Thames at Dartford and to recover the cost by charging tolls to users was awarded to a private sector consortium in 1987. A competition for a privately funded second Severn crossing followed. The Dartford crossing (the Queen Elizabeth II Bridge) was opened in 1991 and is operating successfully. The second Severn crossing is at an advanced stage of construction.

2.3 In 1989 the then Chief Secretary, John Major, announced that in future the Treasury would not require reductions in public expenditure programmes fully to offset privately funded projects. This represented a marked relaxation of the Government's approach to private finance.

The new policy

2.4 The new policy - the Private Finance Initiative - came in the autumn of 1992 and was formally announced by the then Chancellor, Norman Lamont, in his Autumn Statement of that year. Mr Lamont said that:

- self-financing projects undertaken by the private sector would no longer need to be compared with theoretical public sector alternatives;
- the Government would actively encourage the private sector to take the lead in joint ventures with the public sector;

QUEEN ELIZABETH II BRIDGE (DARTFORD - THURROCK RIVER CROSSING)

1. The first major PFI project. It is financially free-standing, the only public sector contributions being the cost of the approach roads and the transfer of the revenue stream from the existing tunnel, which the supplier (the concessionaire) took over. The supplier designed, constructed and operates the bridge, and recovers the revenue from tolls. The concession period is for a maximum of 20 years or until the company has accumulative revenue which exceeds the amount of debt outstanding, whichever is sooner.

2. Although risk transfer to the private sector has been significant, it is subject to two important qualifications:

- as it is expected that the agreed cumulative revenue will be achieved well within the maximum 20 year concession period, in practice most of the demand risk is borne by bridge users and will be reflected in a shorter or longer tolling period;
- as the bridge transfers to public sector ownership after the end of the concession period. If latent defects emerge after transfer, the Government will be responsible for rectifying them.

- the public sector would have greater opportunity to use leasing where it involved significant transfer of risk to the private sector and offered good value for money.

2.5 The new policy had a limited impact in its early months and the new Chancellor, Kenneth Clarke, decided that it needed further impetus. In autumn 1993 he announced the creation of a Private Finance Panel, under the then chairmanship of Sir Alastair Morton (now of Sir Christopher Bland), whose role would be to encourage greater participation in the initiative by both private and public sectors, to stimulate new ideas, to identify new areas of public sector activity where the private sector could get involved, and to seek solutions to problems which might impede progress. In November 1993 the Treasury published *"Breaking New Ground"* which strongly encouraged PFI projects.

2.6 **The emphasis of PFI is away from funding; towards involvement in the design, build and operation of a capital asset by a service provider.**

2.7 Many of the early privately funded projects had involved transport but Ministers responsible for other areas became increasingly interested in applying the PFI to their own programmes. In November 1993 the Parliamentary Under-Secretary of State for Health, Tom Sackville, announced that NHS bodies would not be given access to public funds for capital projects before they have rigorously explored PFI options and shown them to be impracticable. This requirement was subsequently formalised in the NHS Capital Investment Manual. In November 1994 the Chancellor generalised the NHS approach by announcing that in future the Treasury would not approve any capital projects unless private finance options had been explored. He made it clear that he wanted to maximise the scope for and use of private finance, reserving public capital provision for those few areas where private finance was considered inappropriate or could not be expected to provide value for money.

The PFI and local authorities

2.8 Prior to the launch of the PFI, many local authorities had already established successful partnerships with the private sector. Nevertheless, following case-studies and consultations carried out by the Department of the Environment and the Chancellor's Private Finance Panel, it came clear that changes in the framework of financial controls within which local authorities operate would be needed to assist the development of PFI schemes locally. During 1995 therefore a number of new measures were implemented to remove obstacles and increase the flow of private investment. These included:

- fewer controls on the participation by local authorities in companies led by the private sector;
- measures to facilitate the transfer of assets to companies and the movement of local authority companies into the private sector;
- time-limited incentives for local authorities to dispose of specific types of asset to the private sector. The aim was to enable private management and investment in such assets, whilst unlocking additional resources for local authorities to invest in new joint ventures with the private sector;
- wider scope for revenue treatment of leases of non-housing property.

2.9 Further measures were announced in October 1995 to encourage new forms of collaboration between local authorities and the private sector, especially in the improvement of buildings and the rationalisation of land holdings. The changes will:

- encourage arrangements which provide for sharing of facilities between local authorities and the private sector;
- give local authorities greater flexibility to mobilise the value of under-used or obsolete assets, focusing resources on replacement and upgrading schemes;
- encourage authorities to put the private sector in the lead through "design, build, finance and operate" (DBFO) contracts, to replace buildings in the education and other sectors.

Subject to consultation and Parliamentary approval, the new measures will take effect by 1 April 1996.

2.10 In parallel, options are also being considered for extending DBFO arrangements to virtually the full range of local authority capital projects. It is too early to judge whether this will be achievable, but consultations will be taking place with local authority and private sector interests to see if practical options can be identified. Again, the Private Finance Panel is closely involved in this work.

2.11 Finally, the local authority associations in England have decided to establish a private finance unit to promote public/private partnerships and PFI. The unit will be staffed with secondees from local authorities and the private sector, to act as a common resource for local government as a whole. It will help authorities develop new partnership initiatives, disseminate good practice and identify obstacles to further progress. It is anticipated that the new unit will be operational with effect from April 1996.

PFI projects

2.12 There has been a steady stream of projects operated and, to a greater or lesser extent, funded by the private sector since 1992. The following examples illustrate the diversity.

SUMMARY OF DIVERSITY AND TOTALITY

DIVERSITY	*TOTALITY*
Transport Health Defence Accommodation Urban regeneration Information systems Prisons Higher and further education Water and sewerage Other projects	In excess of 1,000 potential PFI projects - capital value around £25 billion - have been identified

Diversity

2.13 **Transport:**

- Skye Bridge, a tolled bridge connecting the Isle of Skye to the mainland of Scotland was built by a private sector consortium and opened by the Secretary of State for Scotland last month, October 1995;
- Heathrow Express, a joint venture between BAA and British Rail/Railtrack, now under construction;
- Channel Tunnel Rail Link for which a contract is expected to be awarded later this year;
- Northern Line trains (see Chapter 4);
- Croydon Tramlink, a joint venture between the London Borough of Croydon and London Transport. Possible private sector partners are currently being sifted following the issue of an OJEC notice (see page 11);
- Docklands Light Railway - Lewisham Extension;
- DBFO roads: a number of schemes to be financed by shadow tolls. Preferred bidders for the first tranche have been announced.

2.14 **Health:** over fifty smaller (under £10 million) schemes are under development or are already in operation. They include:

- waste incineration for South Kent Hospitals NHS Trust (see page 39);
- an MRI (magnetic resonance imaging) scanner for Mid-Sussex NHS Trust;
- a combined heat and power scheme for St. James' University Hospital NHS Trust;
- dialysis services for South Tees Acute Hospitals NHS Trust (see page 42);

- completion of negotiations for a concourse development for Queen's Medical Centre, Nottingham;
- several similar projects in Scotland.

2.15 Completion of negotiations for a number of larger PFI projects is expected within about the next twelve months. They include:

- Norfolk and Norwich Hospital;
- St James' University Hospital, Leeds;
- Swindon and Marlborough Trust District General Hospital;
- Royal Berkshire Hospital (see page 35);
- Bishop Auckland District General Hospital;
- Royal Infirmary of Edinburgh.

2.16 **Defence:** a number of pathfinder projects are being pursued. They include:

- the operation of naval training establishments;
- Tidworth Garrison water and sewerage scheme;
- White (ie non-front line) vehicles for the armed services;
- Devonport Visitors Centre;
- Defence fixed telecommunications system.

2.17 **Accommodation.** The expected model will be for the private sector partner to take over the existing accommodation of the public body, to provide new or refurbished accommodation plus a facilities management service, and to use surplus estate for commercial development. Among the major projects are:

- the Treasury building in Parliament Street;
- DSS's Newcastle estate (see page 45);
- Customs and Excise's Southampton estate.

Guidance entitled "Private Finance Initiative in Government Accommodation" was published recently (October 1995) by the Private Finance Panel and Property Holdings.

2.18 **Urban regeneration.** A large number of schemes involving local authorities and public corporations. The public body normally provides the land and some infrastructure leaving the provision of new buildings to its private sector partner (see examples on pages 47, 51 and 52).

2.19 **Information Systems.** A very wide range of projects ranging in value from £1 million to £500 million. The project to replace the National Insurance Records System (NIRS2) is described in Chapter 4. The Public Services Minister, Roger Freeman, has announced the establishment of a private finance unit dedicated to information systems and technology across government.

2.20 **Prisons.** The Bridgend and Fazakerley prisons DCMF projects are described in Chapter 4. A similar project for a Scottish prison will commence when a suitable site has been found and plans have been announced for two further DCMF prisons in England, with two more to follow subsequently.

2.21 **Higher and further education.** The Further Education Funding Council's PFI register includes £650 million of potential new PFI schemes in 172 colleges, ranging from the redevelopment of whole colleges to smaller schemes for heating systems and lifts. Most new building in higher education is privately funded - capital allocations from the Higher Education Funding Council typically account for no more than 25 per cent of project costs. Greenwich University has undertaken a PFI scheme for new residential accommodation (see page 56).

2.22 **Water and sewerage.** Several projects are in various stages of development in Scotland and Northern Ireland. The most advanced is a scheme by Highland Regional Council for which a contract is expected to be awarded in spring 1996.

2.23 **Other projects.** Worth noting as an illustration of the range of possibilities are:

- the Royal Armouries Museum, Leeds (under construction);
- secure training centres for young offenders, (bids being assessed);
- the Employment Services' new personnel systems project (contract awarded October 1995).

Totality

2.24 These examples demonstrate the diversity of PFI projects. It is also worth noting the substantial volume of projects. **The Private Finance Panel have identified with Government departments in excess of 1,000 potential PFI projects with a capital value of around £25 billion, and with a present value of the payments throughout the projects' lives of between £40 and £60 billion.**

CROYDON TRAMLINK

The project involves a proposed light rail system to link Croydon town centre with Beckenham, Elmers End, New Addington and Wimbledon, to be constructed, owned and operated by the private sector. An invitation to tender was issued to four pre-qualified bidders in October 1995. Notable features of the project are:

- the requirement for legislation, which was obtained before the procurement process began;
- a high level of private sector capital investment. A public sector contribution will also be necessary, justified by the social benefits of the project. It is hoped that the private sector contribution will be around 50 per cent of the total;
- remuneration of the supplier wholly through fares, ie transfer of demand and operating risk. Risks retained by the public sector include those arising from future London Transport fare policy, should it be out of line with planning assumptions.

Chapter 3

Risk transfer and value for money

Fundamental requirements for a PFI project

3.1 There are two fundamental requirements for a PFI project:

i. value for money must be demonstrated for any expenditure by the public sector;

ii. the private sector must genuinely assume risk. The significance of these two criteria differs depending on the type of privately financed project.

3.2 For **financially free-standing projects,** there will be no significant public expenditure on the project itself and the value for money test will therefore not arise in relation to the private sector contribution. However:

- where the project effectively creates a monopoly, for example an estuarial crossing with no convenient alternative routes, the public sector promoter will wish to ensure that users are not exploited, for example by the charge of excessive prices;
- where there are ancillary works undertaken by the public sector in connection with the project, for example link roads with a new crossing, they will have to meet normal investment appraisal criteria.

3.3 The main requirement with projects of this type will be to ensure genuine transfer of risk to the private sector supplier. There should not normally be any guarantees or indemnities payable by public sector to private sector, explicit or implicit, to cushion the private sector supplier against unexpectedly low levels of demand or other forms of project failure (although there may be exceptions where failure is a consequence of Government action).

3.4 For **services sold to the public sector,** the two fundamental requirements are inextricably linked. The concern of the public sector will be to ensure that it achieves value for money for its expenditure. The transfer of risk will be one means of achieving this goal. As a general rule, value for money can be expected to increase initially as risk is transferred to the private sector until the optimum point is reached at which all risks have been allocated to the partner best able to manage them. Any further risk transfer will lead to a decline in value for money. The amount and type of risk that needs to be transferred to achieve optimum value for money will vary from case to case and must be determined in negotiation with bidders. Value for money is tested by looking at alternative ways of securing the same service including a wholly publicly financed project, if one is realistically available in a similar timescale (see paragraphs 3.35 to 3.43 below).

3.5 For **joint ventures,** only the public sector financial contribution to the project needs to be the subject of a value for money assessment. This assessment is based on a comparison of alternative uses of the same money.

Risk transfer

3.6 As already mentioned, **the principle that should govern risk transfer in PFI projects is that risk should be allocated to whoever is best able to manage it. Although there may also be policy reasons to encourage risk transfer, the aim is to achieve optimum risk allocation, not transfer for its own sake.** That said, with financially free-standing projects, it is unlikely that any of the types of risk discussed below, except possibly regulation risk, could beneficially be retained by the public sector. After it has carried out its initial enabling role, the public sector will be at arms length from these projects and will be poorly placed to manage the risks. The guidance in this section therefore applies mainly to projects involving the sale of services to the public sector and, to a more limited extent, to joint ventures.

3.7 Risks come in many forms, many of them project specific, but the categories shown in the box are of sufficient general importance to be worth considering for the great majority of PFI projects.

RISKS TO CONSIDER IN MOST PFI PROJECTS

Design and construction risk (to cost and time);

Commissioning and operating risks (including maintenance):

- operating costs
- availability;
- performance;

Demand (or volume/usage) risks;

Residual value risk;

Technology/obsolescence risk;

Regulation and similar risks including:

- taxation;
- planning permission;

Project financing risk.

3.8 **Design and construction risk** (design, to meet the specified operational requirement, and manufacture for bespoke equipment; design and installation for information systems) includes failure to meet the specified requirement, cost overrun and time overrun. These risks should always be transferred in PFI projects.

3.9 Certain design and construction risks can be and often are transferred with publicly funded procurements but substantial time and cost overruns continue to be a common problem for public sector construction projects. The PFI route sharpens up the incentive on both public sector project sponsors and the private sector supplier because:

- purchasers specify a service requirement not an asset requirement, where payment levels for the service have been agreed in advance, cost overruns on the latter cannot be passed on;

- the private sector supplier receives no payment from the customer until the asset produces a flow of services meeting the performance standards specified in the contract, making time overruns very unattractive;
- as the private sector supplier is responsible for operation of the asset, not merely providing it, it will be greatly to their advantage to ensure that the design facilitates efficient and economical operation.

3.10 Transfer of **commissioning and operating risks,** particularly availability risks, is a key feature of recent PFI deals involving sale of services to the public sector and joint ventures.

3.11 Limited operating risk can also be transferred to a private sector supplier with conventionally funded procurement - by contracting out operation of a publicly owned asset - but greater operating risk can be transferred where the private sector supplier is responsible for provision of both the asset and the service. If the supplier is not also the owner of the asset used to provide the service, there is a risk that the customer will be unable to determine the extent to which asset supplier or service provider should be held responsible for performance failure. This problem can be eradicated with PFI projects.

3.12 While it is difficult to conceive of a satisfactory PFI project which did not involve a transfer of most design, construction and operating cost and availability risk, the transfer of **demand risk** (also called volume risk, usage risk and, where revenue is tied directly to demand, revenue risk) may be more variable. For financially free-standing PFI projects, demand/revenue risk necessarily lies with the private sector supplier. However, where the project is a monopoly, the amount of demand risk faced by the private sector supplier will depend on the contractual arrangements for pricing and the duration of the concession. The case for some protection of the private sector supplier against large demand risks over which the supplier has no control has to be balanced against the importance of the private sector supplier facing the consequences of losing custom because of poor service.

3.13 The position is more complex with sales of services to the public sector where the public sector is sole paymaster and sole customer. This can limit the private sector's ability to manage volume risk. In the NIRS2 contract, the private sector supplier and the Contributions Agency share the risk of variable demand for the system between specified upper and lower limits. Outside the lower limit, demand risk is retained by the Contributions Agency, above the upper limit it is borne by the supplier. In the DCMF prisons project, bidders were invited to bid against requirements including and excluding the transfer of demand risk. The results demonstrated that the transfer of this risk would not be good value for money.

3.14 In cases where the public sector itself is not the end user of the services provided (eg where transport services are provided to the public), there is little reason for sharing demand risk with the private sector supplier.

3.15 Public sector managers of PFI projects should fully explore the transfer of demand risk as a potentially powerful way of increasing incentives for the private sector supplier. However they should not insist on it in the face of evidence that it would reduce value for money.

3.16 **Residual value risk** concerns the value of an asset at the end of a contract, which may or may not be fully realisable. The question of transferring this risk does not always arise. In PFI schemes involving the automatic transfer of the asset to the public sector at the end of the contract (as in the DCMF

prisons and DBFO roads), the private sector supplier will aim to recover the full value of its investment during the contract period. Where asset transfer is not a requirement, leaving residual value risk with private sector suppliers may incentivise them to keep assets in good shape throughout the life of the contract. Factors which might influence the private sector supplier's maintenance policy would include the prospect for further exploiting the asset, for example in extension or renewal of the contract, or the possibility of higher income by discarding the asset and replacing it with new.

3.17 The primary contract period for the Northern Line trains scheme is 20 years; the trains have a life of 36 years. The supplier can be expected to be looking to extend the contract for a further period and to maintain the trains accordingly.

3.18 The NIRS2 contract takes a different approach. At the end of the first contract period, there will be a potential transfer payment. If a new supplier wins the second contract with a bid to use the existing system, the new supplier must pay the original supplier a transfer payment to buy out the system. However, if a new supplier wins with a different solution, no transfer payment will be made and the original supplier must either find an alternative customer for the system or bear the loss.

3.19 **Technology or obsolescence risk** is the risk that the asset will cease to be the technically best way of delivering the service during the lifetime of the contract. It will not always be significant and, even where it is, it will not necessarily be the concern of the public sector customer. If the contract specifies certain performance standards then the customer may be indifferent to the technical means by which these are achieved. On the other hand, indifference may mean missing out on an opportunity for improved performance and value for money through updated technology. Where technology risk is an issue for the customer, it may be dealt with by requiring performance standards to be enhanced in line with an external benchmark, for example in IS/IT this might mean software update as market-leading packages evolve. Another approach might be as suggested for residual value risk: by aiming to ensure that part of the value of the asset has not been recovered at the end of the first contract period, the supplier may be incentivised to ensure that the asset remains competitive.

3.20 **Regulatory or legislation risk** - the risk that the law will be changed in a way which affects the operation of the service - may at first sight appear to be a category of risk which it is not appropriate to transfer because it will be wholly outside the control of the suppliers. The key issue is whether the change in the law is discriminatory in respect of the particular project or service. Risk in respect of changes in law and regulations of general application should lie with the private sector. However, where the regulatory change is specific to the service provided by the supplier (for example changes in prison rules for DCMF prison operators), it may amount to a change in the purchaser's requirement. The test should be one of materiality: the risk of small regulatory changes should normally be borne by the supplier but the contract should have provision for renegotiation in the event of changes with a major impact.

3.21 The presumption should be that general **taxation risk** should be borne by the supplier. Such risk is likely anyway to be marginal. Leases may include clauses which allow the lessor to increase charges when taxation changes would otherwise reduce the return on the investment. Public sector bodies should seek to negotiate the deletion of such clauses provided it would be value for money to do so or, failing that, to ensure that they operate in both directions. The main exception is VAT, where public bodies may agree prices which are VAT exclusive.

3.22 The public sector should seek to transfer responsibility for obtaining detailed **planning permission** (where needed) and associated risks to the supplier as part of the design responsibilities. The public sector should normally retain responsibility for obtaining outline planning permission as it would

impact on the flexibility of funding of any private sector supplier. However, exceptionally, it may be possible to also transfer responsibility for obtaining outline planning permission – perhaps where the supplier is offering its own site for the project. The public sector should be prepared to steer the project through any public inquiry, where:

- the proposals represent a departure from the planning authority's existing development plan; and
- there is likely to be a controversy about the need for the service, and not merely about how it is to be provided.

Wherever possible, planning applications should be consistent with the plan. The Government supports a plan-led system; planning legislation provides that planning decisions should be made in accordance with the development plan, unless material considerations indicate otherwise.

3.23 **Project financing risk** is inherently a risk to be managed by the supplier and its financiers. The public sector should, however, consider whether the terms for a conforming response to an invitation to negotiate are such that the supplier may not be able to obtain finance for the project or make it unnecessarily difficult or expensive; and re-examine the terms where appropriate. The public sector purchaser must have an interest in the ability of the supplier and its financiers to fulfil their contracts.

3.24 **Risk transfer packages.** The optimum risk transfer package – that which maximises value for money – will vary widely from contract to contract and between different types of service. As a general rule, PFI schemes should always transfer to the supplier design, construction and operating risks (both cost and performance). Demand and other risks should be a matter of negotiation with the value for money impact being tested out, where appropriate, through bids on alternative risk transfer bases against minimum and conforming requirements.

3.25 Risks retained by the public sector include:

- the risk of a wrongly specified requirement. Where it is known that requirements cannot be specified in their entirety initially, as in some IS/IT projects, it may be possible to share with the supplier the risk of defining remaining requirements during development and implementation.The public sector still retains the risk in respect of the initial specification;
- risk of criticism. A failure of a public service, even if entirely the responsibility of a supplier, may result in criticism of the Government or local authority along with the supplier.

3.26 PFI project managers should make preliminary judgements at the start of the project about what risk they would like to transfer, bearing in mind the need to test the value for money of the more uncertain elements. This means an assessment should be made at the outset of the risks involved in the activity. Wherever possible, risk should be quantified as the project proceeds. Annex C of the Green Book discusses some methods of doing so. In practice it is often very difficult but if a range of values can be established, sensitivity analysis can be used to see whether the choice between options is affected. In the case of the Northern Line trains project, a full quantification of risk transfer was possible and strongly demonstrated the case for using the PFI route.

3.27 Once it has been decided which risks to transfer, the private sector supplier should be left to manage those risks in the best way possible in the interests of achieving efficiency.

Value for money (VFM)

3.28 Best value for money is the optimum combination of whole life costs and benefits. There are three separate vfm decisions to be taken, though in practice two of them may be made at the same time:

i. whether to proceed with the project at all (ie. to compare its likely costs and benefits with alternative options, including doing nothing);

ii. whether to proceed using PFI or a traditional procurement route;

iii. what supplier to select to provide the asset/ service.

3.29 The first of these decisions should follow an economic appraisal, guidance on which (for central government) is given in the Green Book. The third decision will normally be made after a competitive tendering process and is covered in Chapter 5. This section deals with the second decision.

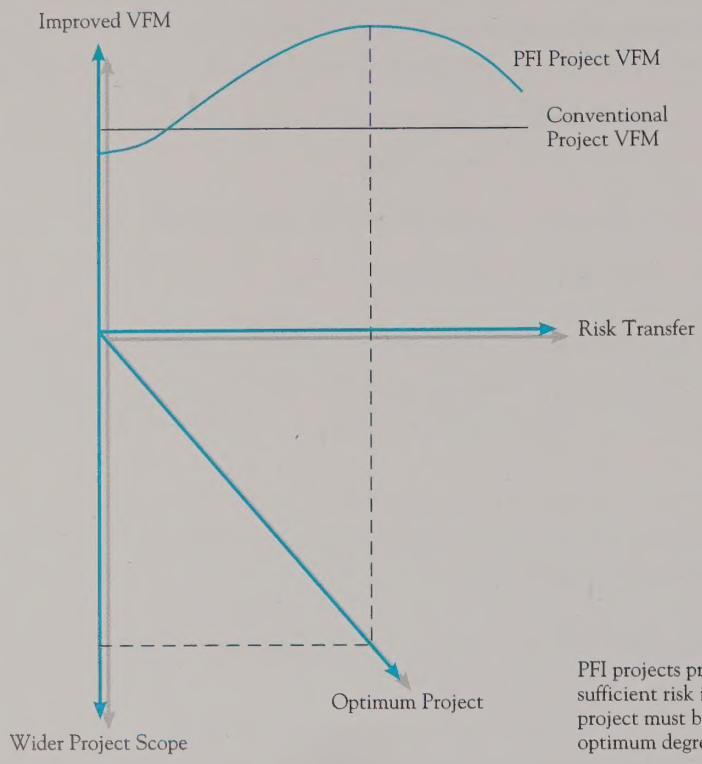
SOURCES OF IMPROVED VFM

There are many ways in which contractors for PFI projects could offer the public sector improved value for money. They include:

- ensuring that assets are fully fit for purpose but no more, that is removing any tendency to over-design or gold-plate and removing the cost pressure from post - contract design changes;
- closely integrating design with operational needs so that the asset can be operated and maintained with maximum efficiency;
- increasing the efficiency of both construction and operation by applying existing expertise;
- making use of new technology and/or new, more effective business processes;
- achieving economies of scale by enlarging the asset and sharing its use between the public sector and other customers (or between two or more public sector customers);
- designing the asset to provide scope for other services to be sold to third party users;
- designing the asset to improve its resale value or its capacity to be transferred to new uses after the end of the contract;
- making easier the introduction of user charges where appropriate as a means of improving the match between supply and demand.

In short, better overall management over the life of the project gives better value for money.

PFI Projects Provide Better VFM



PFI projects provide better VFM – providing sufficient risk is transferred – but the scope of the project must be sufficiently wide to allow the optimum degree of risk transfer.

3.30 The starting point is a clear presumption that the PFI approach will generally be better than a traditional procurement; the better management inherent in a PFI project will give better value for money. As a matter of Government policy, public bodies should always consider private finance options unless it is clear that transfer of project control and risk to the private sector is not feasible. The circumstances in which the latter might be the case include: an overriding operational need for the public sector to provide the service; no prospect, for policy or operational reasons, of transferring significant control and risk to the private sector without disproportionate cost. In some cases existing contractual commitments may make a PFI solution infeasible in the short term. However public bodies should think carefully about the scope for assigning existing contracts before reaching the conclusion that the use of the PFI is ruled out in principle.

3.31 Ultimately, the vast majority of projects across the public sector will be suitable for the PFI. In the short term the PFI should not be allowed to hinder investment activity.

3.32 Managing a PFI project is resource-intensive and requires new skills. Where there is a large number of projects, it might be necessary for a public body to buy in the necessary skills rather than spreading its own skills thinly across all; where possible these should be bought, at least partially, on a "success fee" basis.

3.33 Projects offering the greatest potential for value for money gains from the use of the PFI are likely to be:

- those which maximise the services to be provided by the private sector supplier in association with the asset;
- those with the most scope for transferring risk to the private sector;
- those that have the greatest scope for generating additional revenue flows by sales to third parties.

3.34 Low value projects may offer less scope for value for money improvements. For example, a single bespoke project of small size may require a number of private sector companies of differing expertise to set up a specific consortium. Better value for money might be obtained where the project would be but one item in an existing organisation's portfolio, or where the project is replicable across a number of areas and several projects could be packaged together in a single PFI contract. It is not possible to set a single de minimis level for this. In December 1994 the Government Centre for Information Systems (CCTA) recommended a figure of £500,000 (capital cost) as the de minimis level for privately financed IS/IT projects, but this no longer applies. Projects with a capital cost of less than £100,000 are being taken forward, and departments and other public sector bodies will need to make their own judgements in the light of their circumstances.

VFM: SOME TECHNICAL POINTS

Value for money for PFI projects involving the sale of services to the public sector should be established by comparing the net present value (or net present cost) of the estimated annual cash flows over an appraisal period equivalent to the PFI contract term.

The contract term for appraisal purposes should include any optional extension period if it is reasonably certain at the inception of the contract that the option will be exercised by the public sector customer.

It is important to compare options on a common basis taking account of differences between them in the extent of risk transferred. For example, if in the PFI option liability for repair costs is transferred to the supplier but in the public sector purchase option it remains with the purchaser, the expected repair costs should be estimated and included as part of the costs of purchase (the expected repair costs are the average cost of a repair multiplied by the expected number of occurrences). Wherever possible, the comparison should include the cost of dealing with aspects of asset management such as maintenance in a separate contract alongside purchase.

Public bodies should consult their economic advisors on technical issues affecting the calculation of NPVs, including discount rates and inflation assumptions.

Public sector comparators

3.35 A critical question in deciding whether to go ahead with a PFI option is identifying best value for money. Competition is the best guarantor of value for money. As a result of the competitive process, the best PFI options should emerge. These may involve comparison with a conventionally procured alternative - the public sector comparator.

3.36 Certain kinds of PFI projects do not need a public sector comparator (see chart on page 21). This is an important innovation since the old Ryrie Rules, although it needs to be interpreted sensibly. **Public sector comparators are not necessary for projects which involve no public money or which would not have gone ahead other than as PFI projects.** This includes projects in which a public sector body contributes to a project whose revenue comes primarily from third parties, for example

the Channel Tunnel Rail Link. (In these cases the public sector body simply tests vfm by comparing the value of making this contribution compared with that of using the resources in another way.) It does not have to compare the proposed project with the same project wholly financed by the public sector.

3.37 **The second type of project is one in which the public sector body is the sole, or main, purchaser of the services being provided - for example a prison or IT project. In these cases a public sector comparator should be used but only where one is realistically available in a similar timescale.**

3.38 A comparator can offer assurance that the decision is soundly based and can be justified to auditors. On the other hand, there is little point in a paper exercise designing a comparator when in practice the public sector option is not a realistic alternative; departmental effort might be better spent in testing the market for an innovative PFI solution. A public sector comparator is not required in the circumstances described above. In other circumstances it is for departmental Accounting Officers or their equivalent in other public bodies to decide whether to use a comparator. It is also at their discretion whether to disclose information from the comparator to private sector bidders. Disclosure would be inadvisable in a single tender procurement or other cases where there was little competition between private sector bidders. But, **where there is sufficiently strong competition to promote value for money for the public sector, earlier disclosure of the public sector comparator (partially or in full) will save abortive tendering effort by the private sector on projects where the comparator, even after allowing for public sector appraisal optimism, was substantially below plausible bids.**

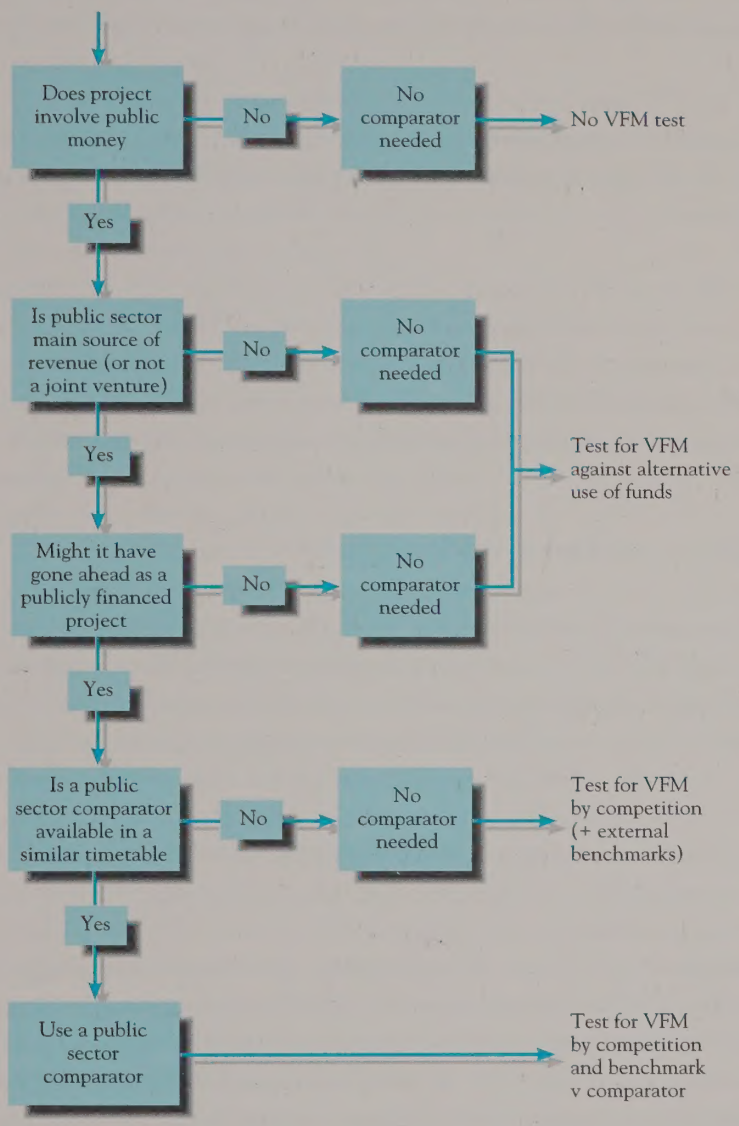
3.39 The construction of a public sector comparator is not straightforward. It will typically be based on a set of hypothetical contracts to design, build and manage a public sector facility, based on recent experience of actual costs. Allowance must be made for the likelihood that out turns are usually higher than initial estimates. Assessment will be needed of the likely costs and risks of both acquiring and then operating an asset to provide a service which meets the performance standards expected of the private sector over the life of the contract. Where the service is a new one there may be no ready made comparisons available, although it should be possible to construct some proxy measure. This calls for an initial identification and costing of risk in a way that is unfamiliar in much of the public sector. Private sector quotes for a PFI project will include their price for carrying the transferred risk and the cost of managing the risks in the public sector must also be taken into account.

3.40 **Where a series of projects of similar size and function follows the PFI route and the first of these projects was compared with a publicly funded alternative, it may be sufficient to ensure that all subsequent projects show value for money at least as good as the first comparator, without preparing a new one in each case.**

3.41 Where it is not realistic to use a public sector comparator, public bodies will rely on competition to secure value for money. There may sometimes be additional benchmarks available; for example, in the case of accommodation projects, the rent of similar standard accommodation; and for telecommunication services, charges for using public networks.

3.42 Private sector bidders are exposed to the financial consequences of their bids, in a way that officials are not in respect of the public sector comparator. This will tend to make the assessment of comparators unduly optimistic about the public sector solution. The use of public sector comparators should not therefore provide a brake on the growth of PFI projects. Experience to date confirms the PFI's potential for delivering significant improvements in value for money.

Public Sector Comparators and the VFM Test



Frequently the extent to which savings can be achieved is not apparent until the end of the tendering and negotiation process. Public bodies should not in general conclude that the PFI option will fail to pass the vfm test before bidders have had a chance to show what they can come up with.

3.43 An initial assessment of value for money should be made early on in the project, when an outline business case is produced (see chart on page 37). A revised assessment should be made in the full business case, after tenders have been received.

Affordability

3.44 PFI projects involving the sale of services to the public sector have the effect of converting what would have been capital expenditure with a publicly funded project into current expenditure in the form of payments for service delivery. Although this should help to make for a smoother flow of payments, it does have implications for affordability in the long run. Indeed, **the economic benefits from PFI projects are reflected in the better vfm they bring over the lifetime of the project, not in the immediate impact on expenditure aggregates.**

3.45 For conventionally procured projects, capital expenditure controls have the effect of limiting long-term expenditure commitments. With PFI projects, public bodies must play close attention to the forward commitments they build up, which may run for 20 years or more into the future.

3.46 **Increasing use of the PFI route instead of public provision will mean that public bodies need less capital expenditure provision and more current provision than otherwise. This implication of the PFI will be taken into account in the annual Public Expenditure Survey, in setting both capital and current provisions.**

3.47 Public sector affordability considerations are not relevant to financially freestanding projects or to the private sector share of joint ventures. It is a central tenet of the PFI that there is no automatic reduction in public expenditure to offset any increase in the private funding of projects that might otherwise have been publicly funded. However the Treasury will wish to keep under review the total need for public expenditure in the light of the overall supply of new investment from all sources.

Public Expenditure treatment of PFI projects

3.48 Public spending in general is recorded on a cash basis. The spending charged to control totals (ie cash limits, EFLs etc) is mainly the cash outgoings in the year in question. Therefore when an asset is acquired using conventional procurement, its cost is charged to the control totals when the cash payments are made; for many assets payment falls in a single year.

3.49 This approach to the control of public spending can give an incentive to bodies to look for ways of spreading the cost of asset acquisition over a number of years in order to reduce the cash amount charged to their control total in any one year.

3.50 A finance lease is a case in point. Such an arrangement is in substance borrowing and such borrowing is more expensive than the Government's normal means of borrowing through the gilt edged market. The capital value of a finance lease is therefore charged to the relevant control total in the year it is entered into - even though cash payments are spread over a number of years.This treatment creates a disincentive on departments to enter into deals which are in substance no more than conventional procurement financed by expensive borrowing.

3.51 The handling of PFI projects is in line with this.

3.52 For projects involving a contribution by the Government to the cost, but with a substantial part of the revenue coming from non-public sector customers (for example the Channel Tunnel Rail Link), the Government cash contribution will be charged to control totals in the years it is made.

3.53 Where the Government is the sole, or main, purchaser of the services involved, for example a prison, the capital cost of the assets involved is reflected in the payment made for the services over a number of years. The public spending treatment will reflect the substance of the transaction. If the transaction is in substance borrowing (like a finance lease), the cost will be capitalised and charged in the first year to deter such poor vfm arrangements. In other cases, only the cash cost in any year will be charged to that year's control total.

3.54 Deals of this second type will not be value for money unless a significant element of risk is transferred to the private sector. This will involve risks across the project's life and not simply in its construction phase. This does not mean the transfer of all risk; some risk (such as legislation risk) is best managed by the public sector.

3.55 **The accountancy profession has an accounting standard which seeks to define finance leases - SSAP21 - and FRS5 has set out some general principles. These are not determinants of whether a project should go ahead; the test is vfm as set out above.** Further guidance on the accounting treatment of leasing is at Annex B.

3.56 It should be noted, however, that FRS5 does not anticipate the range and variety of risks associated with PFI projects. The full scope of risks should be considered and weighed up. However, if the auditors of a public sector body are indicating that under FRS5 a deal is likely to be capitalised on its balance sheet, it means they are treating it as in substance borrowing. Three points arise. First, the question of its scoring in public expenditure. Second, the public body in such circumstances will want to be very clear that the deal is really vfm.

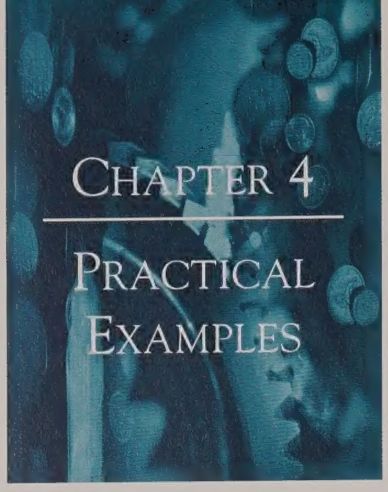
3.57 Third, there is probably scope for a better deal. It is a waste to do the minimum risk transfer needed to get a deal treated as a PFI project. **It is clear from experience to date that the more ambitious deals do not raise the possibility of capitalisation under FRS5. If the possibility of capitalisation exists, departments and public bodies need to pursue determinedly the scope for improving the deal - for example by the lessor taking greater ownership risk or expanding the scope of the project so that the lessor becomes the provider of the service.**

3.58 The principles of FRS5 will be followed in the accounts of all public sector bodies which produce commercial-style accounts, that is including public corporations, executive agencies and the NHS. For all these bodies, the treatment in the public expenditure control total and the national accounts will usually follow the same treatment as under FRS5. The same principles will also usually apply to other central government bodies, and be reflected in the local authority control regime. In this way a project that in economic substance is akin to a conventional procurement financed by borrowing will be capitalised and controlled accordingly. There may on occasion be good PFI projects involving genuine risk transfer that auditors may wish to capitalise under FRS5. In those circumstances the treatment in the relevant control total needs to be discussed further with the Treasury.

Impact of Resource Accounting and Budgeting

3.59 Under the new resource budgeting system to be implemented for central government, all departments and agencies will have annual resource budgets constructed on an accruals basis and including capital charges for publicly owned assets. They will also have an associated financing requirement which will cover their cash requirement for expenditure, including capital expenditure in the current year; the financing requirement is likely also to cover agreed borrowing permissions, for example credit approval. Capital charges will put the cost of publicly funded assets procured conventionally on a basis more comparable to charges for assets required under PFI schemes, as they already do in the NHS.

3.60 **Resource budgeting will mean a more level playing field between resource costs using the PFI route or conventional procurement.** But PFI projects (assuming, as will normally be the case, that they are not capitalised) will differ from a conventional procurement in their impact of the financing requirement. They will not score, whereas conventional procurement will score in full.



A. NIRS2

4.1 The Contributions Agency (CA) of the Department of Social Security (DSS) needed to replace the National Insurance Recording System (NIRS1) and, critically, to have the new system fully operational by April 1997 to support planned changes to pensions legislation.

Project management and procurement process

4.2 By mid-1992 the existing National Insurance Recording System was becoming increasingly incapable of meeting existing and planned requirements. An outline business case, for a publicly funded replacement, was put to the Treasury which led to consideration of a possible PFI solution. Potential suppliers were approached. They indicated that they could take on some of the project risk, offer value for money improvements over the initial business case and meet the timetable. As a result, DSS Ministers agreed to test the PFI option.

4.3 The objectives of NIRS2, of which flexibility to deal with legislative change was of particular importance, had already been established. A project board, chaired by CA's Finance Director, and a project team were created. The team was headed by a project manager and included business, finance, technical, procurement and administration expertise. External legal and financial advisers were also employed; the former at an early stage in the project and the latter somewhat later. In retrospect, earlier involvement of financial advisers might have been beneficial.

4.4 A notice was published in the Official Journal of the EC (OJEC) in July 1994, under the Services Directive negotiated procedure. It invited suppliers to submit expressions of interest in the project. Thirty-four responses were received. A questionnaire was issued to all interested suppliers seeking sufficient information to enable the CA to evaluate the suitability of potential service providers to be invited into negotiations. Responses to the questionnaire were evaluated on the basis of suppliers' business, financial and technical track record. Three suppliers (including a consortium) were shortlisted: EDS/SEMA, Andersen Consulting, and CSC.

Statement of Service Requirement (SSR) and bid evaluation

4.5 The SSR identified the core NIRS2 requirements as contributions processing, compliance to legislation, contracted out provision and delivery by April 1997. Bidders were required to put forward proposals on the core functions and invited to do so on other elements, for example bulk inputting. The service specification outlined the required functionality at a high level only. It specified constraints such as the services that the supplier could not take on and interfaces to other systems. It was designed not to force suppliers down a particular technical path.

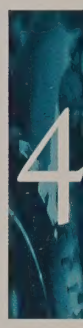
4.6 The SSR also specified minimum and other service levels, including system availability hours, response times and recovery times in the event of system failure. Suppliers were required to submit proposals on the basis of a 5, 7 or 10 year initial contractual period.

4.7 The three shortlisted suppliers were issued with the SSR and invited to submit proposals in response to it. A methodology for the evaluation of these proposals was developed. It involved assessing them under four headings:

i. business/technical: the extent to which proposals met the functional, technical, operational, management and service requirements in the SSR;
ii. value for money: primarily an analysis of forecast charges;
iii. transfer of risk: the value of the risk transfer being proposed;
iv. funding methods: whether suppliers' proposals for funding the contract were credible and acceptable.

4.8 Following receipt and evaluation of the proposals, CA negotiated with the three bidders. In negotiation the CA expanded on their business requirement and discussed suppliers' alternative offers, liability in the event of default and/or termination, and risk transfer. An invitation to tender (ITT) was then issued to each bidder, reflecting points agreed in negotiation. The main innovative offer accepted by the CA, was for the transfer of responsibility for the operation of the existing National Insurance Recording System to the supplier shortly following award of contract. The methodology adopted to evaluate responses to the ITT closely follow that developed for the evaluation of the indicative proposals.

4.9 The contract was awarded on 27 April 1995 to Andersen Consulting.



The NIRS2 agreement

Risk transfer and value for money

4.10 Nearly all design, installation and operating risk has been transferred to the supplier. In addition, two innovative features of the contract involve the transfer of some volume (usage) risk and of some obsolescence risk.

4.11 Volume risk is shared between CA and the supplier as follows:

- an expected volume of transactions has been estimated for each year of the contract;
- payment is related to volume of transactions except that CA guarantees a minimum payment if volume falls below an agreed level - that is CA bears the risk of volume falling below that estimate;
- between the agreed minimum and a capped maximum volume, payment varies with volume and the risk is shared by the supplier and CA;
- above the capped maximum volume, the supplier is responsible for providing a service at the capped price and this risk is borne by the supplier.

4.12 CA have the option of extending the contract for a further 3 years or of retendering the service. If a contract is extended or the original supplier wins the new competition, it can recover the outstanding part of its original investment. If it loses the competition, there will be one of two outcomes:

- if the new supplier wishes to use the original software, it makes a transfer payment to the original supplier to cover the outstanding investment; the transfer payment can be reduced in specific circumstances;
- if the new supplier uses new software of its own, no transfer payment is made.

4.13 The fact that the original supplier is not guaranteed to recover its full investment means that an element of obsolescence risk has been transferred. The effect will be to give the original supplier a strong incentive to keep the system up-to-date to avoid a competitor being in a good position to offer a better solution.

4.14 The value for money of the PFI bids was compared with that of a public sector comparator. All three suppliers offered better vfm than the comparator. The winning supplier offers significant savings over the cost of delivering NIRS2 in-house even if volume is well above expected levels and payments to the supplier are at a maximum.

Key elements of the contract

4.15 **Contract length:** 7 years, extendable for a further 3 years. The 7 year period starts from 1 April 1997.

4.16 **Payment structure:**

- payment for NIRSI equivalent to a proportion of normal running costs;
- no payment for NIRS2 until CA accept delivery of the system;
- in the operational phase, payment is related to the volumes of 15 key business activities (subject to upper and lower limits);
- possible transfer payment at end of first contract period (see above);
- if agreed service levels are not met, CA will receive service credits for the period of failure.

4.17 **Termination** may occur in one of two ways: voluntary termination or default.

4.18 If CA terminates voluntarily in either the pre-delivery or operation phase it must pay the supplier a sum specified in the contract (the termination charge). The payment reduces during the course of the contract. If CA chooses neither to extend nor retender the initial contract, it must make the transfer payment to the supplier.

4.19 The supplier may default either by failing to deliver the system or by failing to meet agreed service levels. If it fails to deliver according to an agreed timetable (with extensions that are appropriate), CA can terminate the contract. If the supplier repeatedly fails to meet agreed service levels, CA can also terminate the contract. In both cases, the supplier will lose payments and the CA has a right to

continue using the software. The supplier is also liable to reimburse CA for additional administrative expenditure. Default by CA has the same consequences as voluntary termination by CA.

4.20 **Force majeure** in the NIRS2 contract means any effect on the performance by a party of its obligations arising from events beyond its reasonable control. It includes fire, flood and third party industrial disputes. When force majeure applies, both sides bear their own costs and attempt to correct the disruption to the service as soon as practicable.

4.21 The **service level agreement** defines the minimum level of performance that the supplier must achieve. It includes standards of availability, response times and recovery times in the event of system failure.

4.22 **Change control.** In the pre-delivery phase, any changes in the planned pensions legislation are covered by the agreed price. In the operational phase, changes are divided into customary changes, such as the standard uprating of social security benefits, and non-customary changes. The former are covered by the agreed price, regardless of the number of such changes. The cost of the latter will depend on the number of function points required to change the system.

4.23 When CA wants a non-customary change to be made, it will specify the required output. The supplier will make a proposal which, if not immediately acceptable, will be the basis of negotiation. If negotiation is not successful then an independent arbitrator will be invited to help with these negotiations. No payment for the change will be made until after delivery has been accepted.

4.24 **Dispute resolution.** In the event of disagreement over the period for remedy of default, the contract provides first for an escalation procedure and, if that fails, for structured negotiations assisted by a neutral adviser or mediator.

4.25 A similar procedure is specified in the event of disagreement on the exact nature of the services to be provided. In the first instance the parties must review relevant background documents to attempt to reach agreement. Failing that, they must use the expert procedure, a mechanism for appointing independent third party experts to give an opinion to assist the parties.

4.26 **Additional revenue streams.** There may be limited scope in the future, within the NIRS project, for the supplier to earn revenue from third parties (subject to agreement with CA).

B. DCMF PRISONS: BRIDGEND AND FAZAKERLEY

4.27 In the autumn of 1993 the Home Secretary announced that as part of the strategy for the further involvement of the private sector in the Prison Service, companies would be invited to design, construct, manage and finance two new prisons, at Bridgend in South Wales and Fazakerley in Liverpool.

Project management and procurement process

4.28 An OJEC notice inviting expressions of interest in the project was published in November 1993. At this stage the restricted procedure was chosen. With hindsight, this was a mistake; **the negotiated procedure should have been used from the outset.** Following a period of consultation in which the views of the private sector were sought, formal expressions of interest and pre-qualification information were received from ten consortia in February 1994.

4.29 Six of them were shortlisted and invited to submit indicative proposals for each prison. An invitation to tender was issued in July 1994 and five bids received in November. None was acceptable as it stood and it became abundantly clear that the restricted procedure was an unsatisfactory procurement route for a project of this type. The Prison Service needed to negotiate with bidders in a way that might have been open to legal challenge. The circumstances were such, however, that, the restricted procedure could be replaced by the negotiated procedure.

4.30 At about the same time, the team running the projects was completed with the appointment of an external project manager. External financial and legal advisers had already been appointed. Internal resources were used to provide expertise on policy, prison operations, prison construction and procurement.

4.31 Following evaluation of the five bids the Prison Service decided to issue a revised invitation to tender to all five of the original bidders.

Specification of requirements and bid evaluation

4.32 The core requirement was that the supplier should provide a specified number of available prisoner places. In order to pass the test of availability, the following criteria had to be met:

- the prison as a whole and each cell must be built and maintained to specified standards;
- the prison regime and the operation of the prison must be in accordance with prison rules and other standards relating to the security of the prison and the control, health and general well-being of prisoners.

4.33 In general, the supplier was free to meet these specified standards in whatever way it chose but there were certain constraints, some of which were imposed by previously - agreed planning agreements - and some which emerged in negotiations with bidders, for example the outer perimeter wall could not be replaced by a fence. The bidding process illustrated the tension between relying on general standards (for example adequate toilet facilities for each prisoner) and making specific judgements about quality levels that could have a significant impact on cost (for example, whether to provide each cell with its own toilet).

4.34 Bids were evaluated against four criteria: deliverability; price; quality; and innovation. All of the five proposals arising from the retendering process were judged to be deliverable; none was particularly innovative. The final choice therefore depended on quality and price, and on an assessment of the risks of awarding both contracts to a single bidder. Preferred suppliers for the two prisons were announced in June 1995: Group 4 and Tarmac consortium for Fazakerley; Securicor, Siefert and WH Atkins consortium for Bridgend. The contracts for Bridgend and Fazakerley are expected to be signed by the end of the year.

The DCMF prisons deal

Risk transfer and value for money

4.35 The two main risks to be transferred to the supplier are:

- design and construction risk. Payments begin when cells are ready for occupation which only occurs when an independent engineer certifies that the prison has achieved the required standards. In addition, if the supplier fails to provide the number of available prisoner places specified in the phase-in timetable, it is liable to pay liquidated damages;
- availability and operating performance risk. Once the prison is in operation payment is only made for places that are available for use. There are no payments for places that fail to meet the required standard. Payments may also be reduced if the supplier's performance falls below specified levels (for example, if there are escapes). The supplier bears the risk of places being made unavailable through, for example, prison riots.

4.36 Operating cost risks are shared. The supplier bears the risk of costs diverging from expected levels in the short to medium term but there is provision for a five yearly review of charges to take account of any major cost changes outside the supplier's control. As a quid pro quo, there is also provision for the prison service to seek a reduction in respect of significant decrease. The Prison Service was concerned that without such reviews the supplier might either have an opportunity to make excessive and unearned profits over the whole life of the contract, or be faced with continuing an undeserved loss- making operation.

4.37 Regulatory risk is also shared. Broadly, changes in prison legislation beyond the supplier's control which significantly affect the supplier's costs give it the right to apply for a review of contract price.

4.38 The supplier is responsible for obtaining detailed planning permission.

4.39 Occupancy (demand) risk remains with the Prison Service. Its transfer was explored during the procurement process but indicative bids demonstrated that it would produce poor value for money. Residual value risk is also retained by the Prison Service: because of the long-term strategic value of the prisons they revert to Government ownership at the end of the contract period.

4.40 The Prison Service thought it would be valuable in this case to assess value for money against a notional public sector comparator as there was no other benchmark available. (It was calculated from figures for publicly funded construction costs and contracted out operation costs.) The NPV of the public sector base case, taking no account of the risk of cost or time overruns, was some £500 million for the two prisons. Including estimates of the likely value of cost and time overruns increased this figure to over £570 million. The NPV of the preferred DCMF contracts was significantly less than the latter figure.

Key elements of the contracts

4.41 **Contract length:** both 25 years of operation with transfer of the prison back to Government ownership at the end of that period.

4.42 **Payment structure.** Payment is per available prisoner place per day (whether the place is occupied or not) up to a maximum number of places (800 for Bridgend; 600 for Fazakerley). There is an option to pay for additional places at a lower rate. The daily rate consists of three elements: a fixed fee; a fee indexed to the RPI and a fee indexed to RPI plus 2 per cent. If the average RPI for the contract period is 4 per cent per annum, the cost of the service will reduce in real terms.

4.43 The basic pricing formula can be adjusted in several ways, including alterations arising from changes to services required, savings arising from security technology changes, five yearly price reviews to reflect other significant changes, and reductions for poor performance. The basic principle underlying these adjustments is that if the supplier exploits or fails to exploit factors within its control, it should take the resulting benefit or loss. Conversely, significant cost factors outside the supplier's control should be a basis for price adjustment.

4.44 **Termination.** The contracts may be terminated voluntarily by the Prison Service, as a result of supplier default or in the event of force majeure. In all cases ownership of the prisons reverts to the Government.

4.45 Voluntary termination may not occur in the first five years of the contract. Thereafter, the Prison Service may give six months notice to the supplier and pay compensation equal to the value of the supplier's shareholders' equity plus the lender liabilities.

4.46 Default occurs if the supplier fails to meet the terms of the contract or if certain other contractually specified events occur (for example there is a change of control of the supplier without the consent of the Prison Service). The supplier must be given 30 days to make proposals to rectify the problem. If the Prison Service approve the proposals, the supplier has a further period to rectify the problem. If it fails to do so, the Prison Service must allow third party lenders to the supplier 90 days to find a substitute entity to perform the obligations of the supplier. If the substitute entity is not satisfactory to the Prison Service it can terminate the contract by paying the supplier the lesser of the NPV of the contract and the lender liabilities.

4.47 Force majeure events are narrowly defined (for example war and nuclear contamination of the site). In the event of termination on these grounds, the Prison Service pays the supplier the lender liabilities.

4.48 Overall the effect of the termination clauses is to provide both parties with an incentive not to terminate the contract and to provide a mechanism for taking account of the asset value of the prison.

4.49 **Performance measures.** The supplier is required to perform satisfactorily in five areas:

- keeping prisoners in custody;
- maintaining order and discipline in a safe environment;
- providing decent conditions for prisoners and meeting their needs;
- providing positive regimes;
- helping prisoners prepare for their return to the community.

4.50 Points are awarded for specific failures in each of these areas (for example assault on inmates, failure to provide meals). If points for poor performance reach specified levels they result in fee reductions. The supplier is also required to meet the targets contained in a strategic development plan for achieving continuing improvements to the custodial service.

4.51 **Insurance.** The supplier is required to take out commercial insurance for the prison and its contents and for public liability. Although there is no reason to assume that insurance for malicious damage will be unobtainable (it is available for the four existing contracted out prisons), third party lenders were unwilling to risk their investment. In the event of the supplier being unable to obtain commercial insurance for malicious damage, through no fault of his own, the Government has agreed to act as insurer of last resort.

C. NORTHERN LINE TRAINS

4.52 The Northern Line of London Underground is one of the busiest sections of the network. It provides around 108 million passenger journeys per annum (some 15 per cent of the total in 1994-95). It generates some £110 million in revenue and costs about £90 million per annum to run. There are 50 stations, 2 rolling stock maintenance depots and in all, some 2000 staff are employed on it. For some considerable time, it has been the candidate for major modernisation, the key benefits of which would include increased revenue, substantial passenger benefits and an opportunity to reduce costs.

4.53 In October 1993, LUL received an offer from ABB Transportation Limited to provide new trains for the line under a leasing deal.

Project management and procurement process

4.54 When LUL received the ABB offer, it was not clear that replacement of existing rolling stock was the best way forward. A thorough examination of the business options, including refurbishment of existing trains, was undertaken by LUL in consultation with the Department of Transport, HM Treasury and the Private Finance Panel. By 1993, the rolling stock comprised mainly 1959 vintage trains, vehicles which were becoming increasingly unreliable and costly to maintain. The principle conclusions were:

- that the acquisition of new trains was justified in cost benefit terms;
- that PFI should be explored and that a competition was necessary to demonstrate value for money.

4.55 A project team, known as Project Archer, including specialists in finance, engineering, procurement, human relations, operations and business strategy had been set up to examine the various business options. Following the decision to explore the PFI route, it was supplemented by external financial and legal advisors. At an early stage in the project, a small informal group consisting of representatives from LUL, DoT, the Treasury and the Private Finance Panel was set up to deal with the policy issues raised by the ground breaking PFI project. It proved very successful in expediting business.

4.56 LUL published a periodic indicative notice in the OJEC in April 1993 using the negotiated procedure. Bidders were limited to those companies which had pre-qualified in accordance with

procedures advertised by LUL in the OJEC in 1992. Four companies were subsequently invited to tender. Bids were received from three of them and two of those, ABB and GEC ALSTHOM, were subsequently shortlisted.

Specification of requirements and bid evaluation

4.57 LUL was faced with a considerable challenge since it had been clear from the start that structures used for previous rolling stock leasing deals would not be acceptable in this case. Something more innovative was needed. At the same time, it was necessary to demonstrate sufficient transfer of risk to meet the requirements of the PFI. In practice, an answer was found which met both these requirements: the team looked away from simple rolling stock leasing to pursue a quite different concept - that of train service availability. LUL emphasised that it was seeking a complete service, with the supplier taking on full responsibility for the design, manufacture, maintenance and cleaning of both trains and associated trackside equipment (for example closed circuit television).

4.58 The requirement would be for a guaranteed number of trains for peak service being made available and then running reliably whilst in service; it was up to the supplier to achieve this level of availability, taking account of breakdowns and servicing. In pursuit of this, a key feature of the proposed arrangement was that the supplier would take responsibility for the two rolling stock depots. LUL on the other hand committed to the maintenance of a specified environment and track standard to enable the supplier to plan with some certainty.

4.59 This output based approach to specification produced bids that differed markedly in cost, benefit and risk streams and profiles. LUL put considerable effort into producing an evaluation methodology which took all these variables into account, ascribing where possible, quantified values to them. The main evaluation criteria were the level of usage payments (and therefore value for money), the level of risk transfer, the level of passenger benefits achieved and importantly the ability for LUL to measure the supplier against clearly stated performance criteria.

4.60 GEC ALSTHOM was announced as the preferred bidder for the project in December 1994, after signing Heads of Agreement, and the contract itself was signed in April 1995. It is expected that the trains will be delivered in a period from mid 1996 to late 1998.

The Northern Line Trains deal

Risk Transfer

4.61 The Northern Line contract transfers the following risks to the supplier:

- **design and construction risk.** The supplier carries risk for the design, manufacture and delivery of the trains and equipment. However, LUL continues to bear the risk of maintaining a specified environment such as track standard and tunnel profile;

- **service availability.** The supplier is responsible for specifying the number of trains (including the number of spares) against a maximum specified service requirement;

- **performance risk.** The supplier carries risk for the performance and reliability of the trains throughout the 20 year primary usage period. LUL has an option to extend into a secondary period on the same basis;

- **residual value risk.** LUL is committed only to procure a service for 20 years representing a significant residual value risk to the supplier;

- **early termination.** The supplier must achieve a pre-agreed performance and reliability target, substantially better than the present best on the underground or LUL can exit the contract.

4.62 Revenue risk in the context of the Northern Line contract remains primarily with LUL but the contract gives it the option of introducing a risk sharing arrangement with the supplier. LUL and the supplier are still discussing detailed options within the framework prescribed in the contract.

Value for Money

4.63 A lease versus buy analysis was prepared in order to demonstrate that the train service contract provided better value for money when compared to the equivalent purchase of trains, equipment and services. It was assumed in doing this analysis that the purchase could be achieved to the same timescale as under the trains service contract. Whilst unrealistic, given capital constraints, it did represent the most conservative assumption. In preparing the analysis, the following key issues were take into account:

- **time value for money.** Taking account of when payments are made;

- **tax benefits.** This was included as a cost to the leasing side and represents the view of Treasury that such tax benefits are a cost to the Exchequer in terms of tax revenues foregone.

- **expected value of risk.** This represented the expected value of costs which are contingent and variable which LUL may have to bear under trains service contract and purchase scenarios.

4.64 The value for money of the PFI deal was compared with that of a publicly funded alternative. Cash flows were discounted as per HMT guidelines for leasing deals. LUL generated a capital cost comparator using recently acquired data from the purchase of rolling stock for the Central and Jubilee lines. Including the value of risk transfer, it is suggested that the train service contract is in excess of 20 per cent better value for the public sector compared to the purchase alternative over 20 years.

Key elements of the contract

4.65 **Contract length.** 20 years from the delivery date of the first train. LUL can either terminate at this point or extend into secondary and perhaps tertiary periods.

4.66 **Payment structure.** Payments increase pro rata over the delivery period. On completion of the delivery period, a fixed cash flow is activated which escalates at a pre agreed annual percentage. This may be adjusted to reflect, for example, failure to meet specified performance levels, and changes in corporation tax (up or down).

4.67 **Termination.** There are provisions for either LUL or GEC default and also for the early termination of the contract in the event of consistently poor performance. The contract describes how the relationship changes to cater for such events.

4.68 **Hand back.** One of the practical problems to overcome was how to deal with the hand back of trains if for any reason the contract terminated. LUL cannot for example be in the position of having to hand back all the trains immediately such an event occurs. Neither would it be logistically possible to effect such a process in practice. A hand back extension provision exists therefore to properly manage in a controlled way the return of trains should a termination event occur.

4.69 **Accounting.** The resulting transaction was not therefore classified as a finance lease as per SSAP21/FRS 5.

Conclusion

4.70 The novel train service contract will provide immediate and ongoing benefits to LUL and its customers, benefits which will be further enhanced once associated work such as resignalling of the Northern has been achieved. It is a watershed for LUL in that it outsources for the first time, the provision of train supply and maintenance, including ownership risks, to a private sector supplier. It should stimulate an increasing willingness by LUL's suppliers to offer innovative forms of service provision contracts for other PFI projects under development, and prove a milestone for LUL and the PFI.

D. OTHER EXAMPLES

4.71 Other examples are included in boxes through out this document:

Queen Elizabeth II Bridge (page 7);

Croydon Tramlink (page 11);

Royal Berkshire hospital - acute service rationalisation (opposite);

South Kent Hospitals - waste disposal (page 39);

South Tees - dialysis service (page 42);

DSS Newcastle Estate (page 45);

Castle Court, Caerphilly (page 47);

English Partnerships (page 51);

University of Greenwich - residential accommodation (page 56).

ROYAL BERKSHIRE & BATTLE NHS TRUST: ACUTE SERVICE RATIONALISATION

1. The NHS Trust has reviewed the PFI options for the entire project, costed at around £56 million. Approval has now been given for the first phase of the developments at the Royal Berkshire hospital to proceed under a PFI proposal. In this phase the supplier will provide car parking, office accommodation, leisure and retail facilities and a private patient's wing. The capital cost of this element of the project is around £15 million.

2. The project is essentially a fixed price contract for car parking and office accommodation with the Trust sharing in the financial flows from the commercial developments (through more favourable rental arrangements) and receiving income from work generated from the private patient's facility. The private sector are designing, constructing, funding and managing all aspects of these facilities. The PFI deal transfers the following specific risks to the private sector:

- availability risk on all elements of the project (through penalty clauses);
- operating risk on all elements of the project through fixed price contract for car parks and accommodation, with the latter subject to regular rent reviews in line with local property market conditions;
- demand risk on the car parking, retail and private patient elements and a small element of demand risk on the office accommodation (a third of office space to be let commercially).

Chapter 5

Managing a PFI Project

5.1 The process of managing a PFI project may, for convenience, be divided into three phases:

- planning;
- procurement;
- contract management (post-award).

In practice the planning and procurement phases are likely to run into one another without a clear break. Similarly, even though award of contract may seem to mark a watershed between the procurement and contract management phases, in practice these two stages will also overlap. The contract management process effectively starts as soon as the decision to undertake a procurement has been taken. Many of the issues that will be critical to the successful management of the contract will have to be settled before an award is made.

5.2 The flowchart (opposite) shows the PFI management process as a whole in schematic outline. It is intended to be indicative only. PFI projects differ very widely. Not all of them will have exactly the same elements and the order in which these elements occur will vary. If a particular project does not fit the model, it should not be forced to do so.

Planning phase

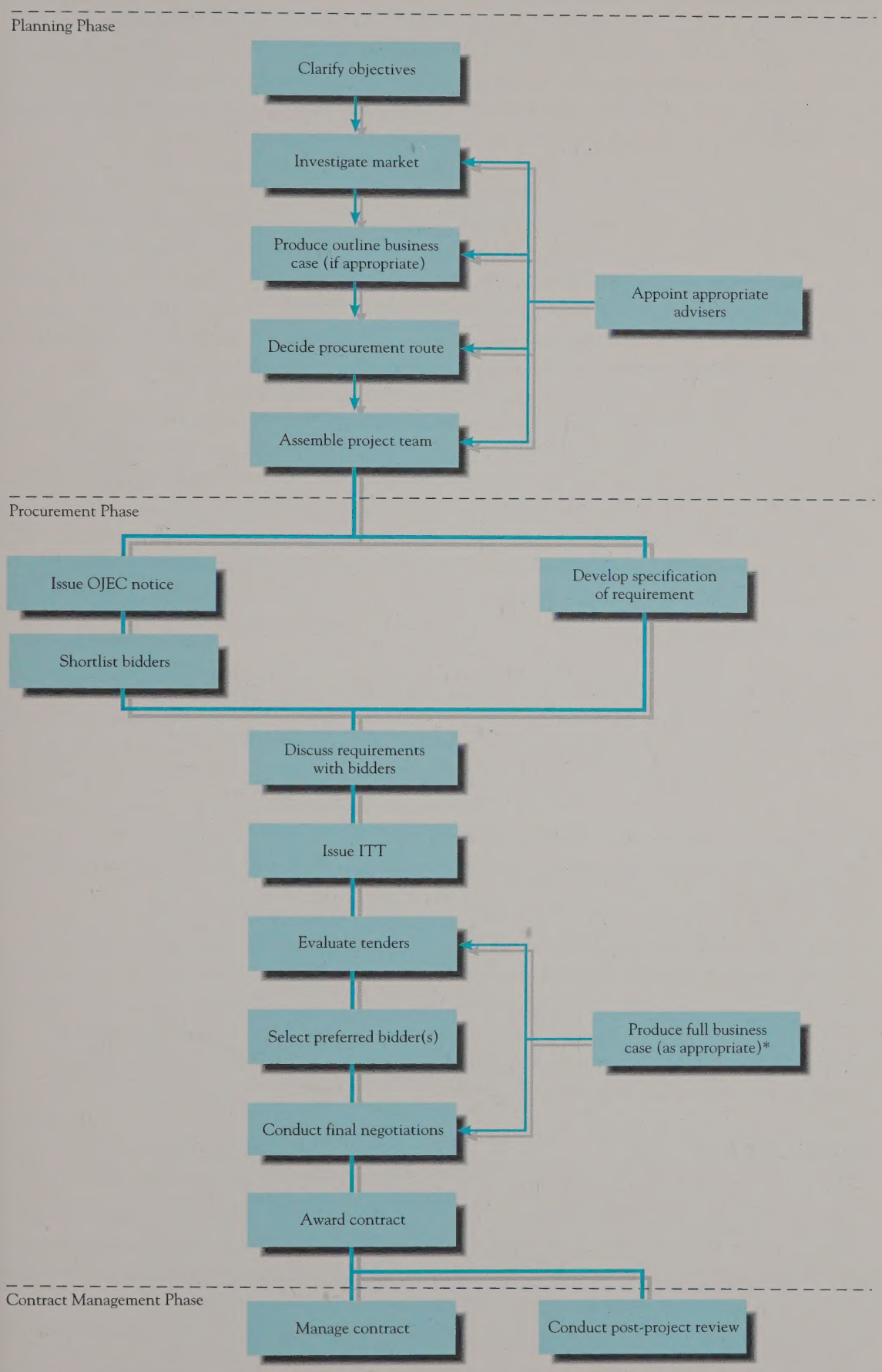
5.3 The planning phase starts with the recognition of a problem or opportunity and continues until a decision has been made to undertake procurement using the PFI route (or not).

Clarifying objectives

5.4 The first task is the clarification of objectives. Typically, problems present themselves in practical terms: for example, our information system no longer has the capacity to do everything we need it to. But the obvious practical solution will not necessarily be the best one. To tease out underlying objectives it is often useful to ask what those in central government will be familiar with as "prior options" questions. Does this activity need to be done at all? If it does, could it be left entirely to the private sector? If not, what role can the public sector most usefully play: an enabler; a purchaser of private sector services; or, if those are not feasible and value for money, an asset owner and service provider in its own right? (There may be other variants.)

5.5 **As well as these prior options questions, public bodies must also consider how possible solutions to the problem at hand fit in with the wider business strategy of the organisation. Piecemeal decisions to acquire assets or services taken without reference to each other or to longer term corporate plans may add up to a very incoherent whole.** This will be particularly true of information systems.

The PFI Project Management Process



* Including using a public sector comparator, where relevant.

5.6 The third aspect of the clarification of objectives is to **think through in more depth, without at this stage drawing up a detailed statement of requirements, what it is that is needed in terms of outputs. This task is sometimes described as identifying critical success factors (which must be measurable).** It will also be useful at this point to try to identify the main risks and to take some preliminary decisions about how they should be allocated; for example, what will be the likely impact on costs and benefits of transferring demand risk to the private sector?

5.7 It may be necessary at the outset to undertake some initial exploration of the market to discover likely levels of interest and capacity to undertake the project. Informal soundings may be sufficient but care must be taken not to restrict or distort competition or to give one supplier an unfair advantage over another in any subsequent tendering process. Alternatively, a formal Request For Information, published in the OJEC, may be made. Occasionally a private sector organisation will itself come forward with a PFI proposal. The circumstances in which such proposals need not be the subject of competition are discussed in paragraphs 5.16-5.20.

5.8 The amount of effort that needs to be put into clarifying objectives and exploring the market will depend upon the size of the project and the extent to which it is in a new area. If the expected expenditure on the project is large and the market untried, it may be worth conducting a feasibility study before deciding whether to proceed further. Close involvement of the private sector in such studies is likely to add plausibility to their conclusions. An OJEC notice could be followed by a consultation document and discussions with interested parties before going further.

Outline business case

5.9 The conclusion of this early work should be an outline business case. The case should address whether the project should go ahead at all and, for low value projects, whether a PFI route is likely to offer value for money. Although there is a presumption in favour of the use of PFI (see paragraphs 3.28-3.31 above), tendering is expensive and public bodies should only put the private sector to this expense for low value projects if the outline business case indicates that there is a reasonable chance of letting a PFI contract. However, when making this assessment it should be borne in mind that the actual vfm of PFI deals is frequently greater than was apparent at the start of a project (see paragraphs 3.35 to 3.43).

5.10 Public bodies should establish the extent of their delegated authority to proceed or not with PFI projects. Where they need Treasury authority before they can award a contract, they should approach it at outline business case stage rather than waiting for the full business case. Its early involvement will reduce the risk of nugatory work later. Treasury specialists and spending teams will also be willing, within the constraints on their resources, to help public bodies and work up projects by sharing experience drawn from across government.

Assembling the team

5.11 If a project management team has not already been put together at an early stage, it must be created before the start of the procurement process. It is essential that it should be multi-disciplinary (or cross-functional) and should include representatives of all those who have a significant interest in the outcome of the project or who have expertise in the areas of major importance. The precise composition of the team will vary from project to project but in most cases it is likely to involve at least the following:

- a project sponsor (who may also cover one of the other areas below);
- those responsible for policy or business strategy;
- service users or, if different, those who have an operational interest in the service;
- procurement specialists;
- technical experts (depending on project, for example IT or construction);
- financial advisors;
- legal advisors.

5.12 Financial and legal advisors may need to be brought in from outside. All the others may, and in some cases must be, internal resources. Where it is sensible and practicable, public bodies should try to use internal resources whenever possible on PFI projects in order to build up the skills and experience needed to run such projects in future. They should consider how to make best use of these resources, for example by ensuring that their career development arrangements provide opportunities and encouragement to those with experience of the PFI to apply it to new projects. It will also be sensible to learn and take advantage of the experience of other similar bodies - for example, other health authorities or NHS trusts by sharing knowledge and lessons.

5.13 Securing a good project sponsor will be critical to the success of the project. He or she will frequently have to negotiate with senior figures from private sector companies and will need the ability, confidence and credibility to do so.

5.14 When appointing external financial advisors, public bodies should look for firms that have knowledge of the PFI, a track record on providing practical, pragmatic advice which can help the team assess risk, and experience in dealing with both public and private sectors. For external legal advisors, the advice of in-house lawyers (where they exist) should first be sought. The qualities that will be

SOUTH KENT HOSPITALS NHS TRUST: WASTE DISPOSAL

A contract has been let for the construction and operation by a private sector supplier (White Rose Environmental) of a new waste incinerator at William Harvey Hospital in Ashford. The capital cost of the incinerator is £3.5 million and the annual operating cost £1 million. Land for the plant is being leased to the supplier for 25 years. The project will:

- transfer construction and operating risk to the supplier;
- provide a lower cost service than the public sector alternative;
- place the requirement to meet environmental protection legislation with the supplier, who has the experience to deal with it;
- meet the incineration needs of nine participating NHS Trusts and provide a supply of steam for the host hospital;
- link price increases to changes in the RPI.

particularly required include experience of dealing with PFI contracts in the relevant area (for example, IT), a good understanding of EC procurement law, and for local authorities and the NHS a familiarity with vires issues.

5.15 Where possible, external advisers should be retained partially, or in full, on a success fee basis.

Procurement process

Competition

5.16 Competition is central to public procurement, both as a means of securing value for money and to help guard against corruption or the appearance of it. As with any other public procurement, the normal presumption should be that PFI projects will be competitively tendered.

5.17 However the Government is anxious to encourage private sector companies to come forward with innovative ideas. In some cases they may be inhibited from doing so by the fear that their ideas will be made known to and picked up by their competitors unless they are guaranteed the security of a single tender process. Public bodies may wish to consider a single tender procurement procedure for PFI projects, subject to complying with EC procurement rules, in the following cases:

- where a private sector promoter identifies an entirely new project;
- where a private sector promoter comes forward with a project in response to an invitation from a public sector body based on the delivery of outputs which are not specifically defined but which come within broad functions, policies or initiatives; or
- where a private sector promoter proposes to proceed with a project already identified by the public sector in a way which has a genuinely innovative element.

EC procurement rules require competition in some circumstances but not in others (see Annex C).

5.18 In considering a single tender procurement the public sector customer:

- should have reason to believe that the implementation of this innovative proposal would produce better value for money than alternatives;
- may wish to take into account whether or not, if a competition were held, there would be a real risk of competitors making use of the original promoter's innovative idea.

5.19 There may be occasions when competition is not possible. For example, where a private sector promoter proposes a joint venture using an asset (for example, land) which it owns and which it is not prepared to sell. The decision facing the public sector body in such cases is therefore whether a contribution to that project would be better value for money than alternative uses of its funds.

5.20 Where they do not seek competitive tenders, public bodies must establish the financial, commercial and technical capacity of the promoter and its general professional expertise. They must also consider appropriate means of safeguarding public funds by limiting contributions to joint ventures and levels of spending on services. These means could include independent checking of cost estimates, monitoring of actual expenditure and possible later adjustment of sums paid. These arrangements will be additional to safeguards needed to ensure that capital investment supported by public sector payments is actually undertaken.

5.21 When competition is used, the process should be started early in the life of the project in order to give the private sector the greatest scope to influence project development and take the leading role in its design.

5.22 Unless projects fall below the thresholds of the EC procurement directives, which is likely to be comparatively rare, the first major step in the competitive process will be to publish a notice in the OJEC. **The use of the negotiated procedure for all PFI projects is strongly recommended where the conditions for using it are met.** Although there are restrictions on the use of this procedure, they are unlikely to prevent its use for most PFI projects. Experience has shown that the restricted procedure provides inadequate scope for negotiations with bidders. A more detailed discussion of EC procurement rules is given in Annex C.

5.23 Although the form of the OJEC notice will vary from project to project, it is frequently convenient to frame it as a request for expressions of interest. The scope of the initial OJEC notice is crucial to later procurement. If drawn too tightly, innovation is restricted and potentially attractive solutions may have to be rejected. Unless pre-qualification has already taken place prior to the start of the project, companies expressing an interest should be asked to provide basic information about their financial standing and commercial and technical capabilities and relevant experience. The information requested should be limited to what is essential to assess the capacity of bidders to undertake the project, including its financial aspects, and their general professional expertise. It should be used as the basis for an initial shortlisting.

5.24 **Because bidding is an expensive process, no more than three or four bidders should normally be invited to provide a full tender.** It may not be possible, or desirable, to reduce those interested in the project to three or four in a single shortlisting exercise. Under the negotiated procedure (see Annex C) there is more scope than under the restricted procedure for further shortlisting, if necessary.

5.25 Bidders may be invited to submit outline or indicative proposals which may be the basis of discussions intended to give the public sector purchaser a better idea of what each bidder can offer. However in fairness to bidders the shortlisting process should not be protracted. In general, the period between publication of OJEC notice and award of contract should not be longer than 12-15 months (NIRS2 was completed in under 10 months), with the greater part of that time being taken up in discussions and negotiations with the three or four final bidders.

Specification of requirements

5.26 The requirements that the procurement is designed to meet should have been identified in broad terms at the planning stage as part of the clarification of objectives. A more detailed specification of requirements should be produced in the early stages of the procurement process so that by the time the final bidders have been selected, it is in a form that can be discussed with them.

5.27 It is essential for PFI projects to specify requirements in output and performance terms. Public bodies which procure large capital assets using public funds typically have detailed manuals specifying, for example, the designs, materials and components which should be used. **A conscious effort should be made to break away from previous manuals and to concentrate on stating what is needed, not how it is to be provided. The focus should be very firmly on the service that is required not on the asset that will help to provide it.**

SOUTH TEES ACUTE HOSPITALS NHS TRUST: HAEMODIALYSIS SERVICE

A private sector company: (UK Renal Services Limited) has been given a 7 year contract to provide haemodialysis treatment using 10 dialysis machines based on the Darlington Memorial Hospital site. The contract transfers most risks, including demand risk, to the supplier. Payment is based on a fixed cost per treatment, subject to an annual review. Consultants of the South Tees Acute Hospital NHS Trust decide who should use the facility and users remain under their care. The need for more hospital based haemodialysis has been met without increasing the cost per patient.

5.28 Examples of output specifications are:

- for accommodation, a description of the number of people to be accommodated, their groupings and their requirements for meetings etc, not a floor plan;
- for information systems, a statement of the amount and type of data processing to be undertaken, not specific hardware and software (although there may be constraints, for example interfaces with other systems);
- for vehicles, the tasks to be performed and the capacity that must be available for use at a particular time, not the total number of vehicles to be built (or the type of vehicle if there is scope for choice).

The effort that may be required to get away from thinking in terms of concrete technical solutions should not be underestimated.

5.29 **The reason for relying on output requirements is to give the supplier the maximum scope to innovate or otherwise to use its skill and experience to design efficient solutions without being constrained by past practices.** As one of the keys to the success of PFI projects will be the close integration between asset provision and the associated service, it is essential that those providing the service should have the opportunity to design the asset in the way that they judge will be best suited to the delivery of the service.

5.30 A requirement which concentrates only on essential outputs will generally give the supplier more scope for innovative solutions. However, output specifications should not be so general that they give bidders no indication of the cost/quality trade-off preferred by the purchaser. The chart opposite illustrates the sub-optimal result that can occur in these circumstances. The purchaser therefore faces the sometimes difficult task of specifying a preferred level of quality without unduly constraining the options open to the supplier. One way of tackling this problem is to supplement the statement of requirements by a more detailed indicative specification. The supplier would not be expected to comply with the details of the specification but would be required to produce a solution of a comparable standard, or better.

5.31 All the final bidders should be given an opportunity to comment on the specification of requirement before it is finalised. They may be able to suggest changes that would enable them to put in a better bid without compromising the underlying objectives of the project. It will also give them the opportunity to seek supplementary information. If a material change is made to the specification once

it has been issued, this should be conveyed to all bidders. The appointment of liaison officers from the project team to work closely with each bidder should be considered.

5.32 In addition to consulting bidders about the requirement, project managers should:

- tell bidders clearly what risks they would be expected to take on and what risks are negotiable. They may be asked to bid against an indicative profile of risk transfer and invited to submit alternative bids on other bases;
- provide them with draft heads of terms covering key contractual issues (such as those discussed in Chapter 6) but in an open way that allows scope for innovative responses.

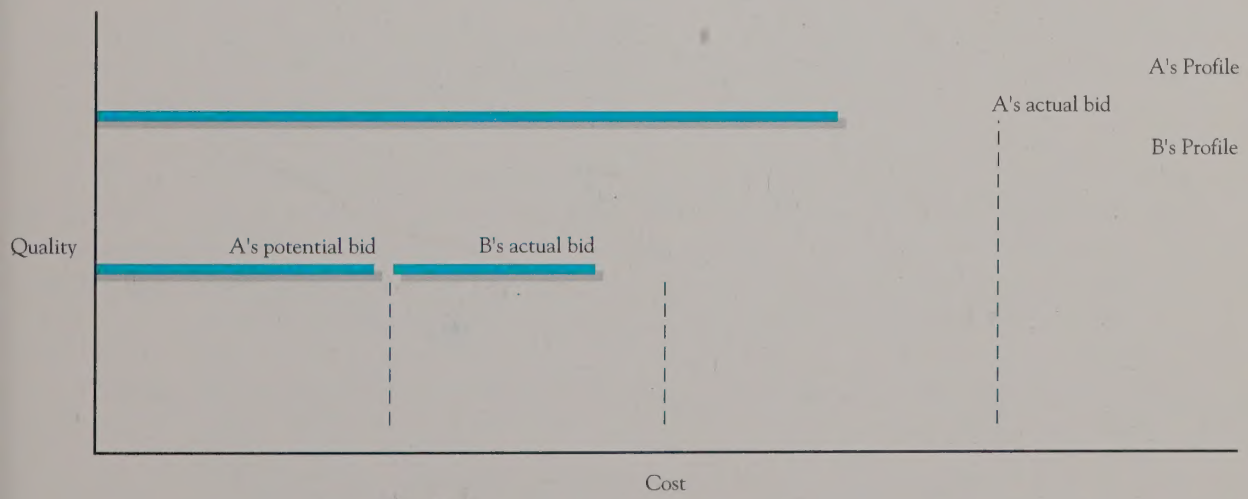
5.33 In the course of these discussions, bidders may float possible ideas to find out whether they would be worth working up for inclusion in their tender. When considering such ideas, project teams need to bear in mind two important principles which may sometimes be in tension:

- the need to ensure that all bidders are playing on a broadly level field;
- the need to preserve each bidder's intellectual property rights.

5.34 The NHS came up with a way to overcome difficulties caused by the assertion of intellectual property rights where an attractive proposal was made for the use of some land that had not been included in the original specification. It could be dealt with by inviting the other bidders to make proposals for the use of this land without telling them what the first bidder's idea was.

5.35 **Public bodies should not expect to combine parts of one bid with parts of another, either at this or at later stages of the bidding process.** Where in exceptional circumstances they believe that this is desirable, they should ensure that the necessary agreement is obtained from the bidders concerned and, if they fail to win the contract, arrange for appropriate compensation to be paid.

Quality/Cost Trade-Off



The above diagram shows the cost/quality profiles of two bidders, A and B. A has lower cost than B for every level of quality. As the purchaser did not specify its preferred cost/quality trade-off, A put in a higher cost/higher quality bid than B. If on receipt of the bids the purchaser were to decide that the quality level proposed by B was satisfactory, it might (in the absence of evidence about the cost/quality profiles of the two bidders) prefer B's bid. However at the level of quality selected, A could have put in a much cheaper bid.

Bid appraisal and award of contract

5.36 When the specification of requirements has been finalised it should be issued as part of an invitation to tender (ITT). Negotiations with bidders (under the EC negotiated procedure) may continue in this phase provided that fair competition is maintained.

5.37 Because PFI projects are complex, much time and effort will need to be devoted to the appraisal of bids. Appraisal criteria should be agreed in advance and notified to bidders as part of the ITT (but the weighting which will be applied to the individual criteria to reach the overall appraisal need not be notified to bidders). In addition to cost, quality and risk, the appraisal procedure will need to assess:

- deliverability;
- robustness.

5.38 Although public bodies are ultimately only interested in the outputs of PFI contracts, they will wish to be assured that bidders can in fact deliver what they claim. In order to assess deliverability, project teams will probably require a fair amount of information about how the bidders propose to achieve the specified outputs. They will also wish to be assured that the financing arrangements put in place by bidders are secure. The extent of equity participation and the relationship between, and respective interests of, the various members of a bidding group including its financiers are critical factors.

5.39 Financing arrangements are also likely to be important in the robustness of bids, that is the extent to which they will be able to stand up to adverse circumstances. Contingency arrangements in the event of failure should be investigated. They might include parent company guarantees, bank guarantees or insurance.

5.40 Although the appraisal should use quantified data wherever possible, it is inevitable that some important factors will be unquantifiable. Appraisal boards should therefore be prepared to take a reasoned, judgemental approach when making their recommendations.

5.41 Where the tendering process is particularly expensive for bidders, public bodies may consider making arrangements, announced in advance, for refunding part of their costs. This may be necessary in some cases to generate enough interest to provide a genuine competition. Such arrangements are not expected to feature in many PFI projects, but have been made in a small number of cases where the investment required by bidders is very substantial and unlikely to be of use in foreseeable future competitions. The principal example is the competition to build and operate the Channel Tunnel Rail Link.

5.42 The outcome of the appraisal will be a recommendation either about immediate award of contract or, more likely if the project is a complex one, about the preferred bidder. Experience indicates that these final negotiations can be intense and time consuming. Although the points dealt with will be essentially ones of detail, they may be critical to the success of the contract.

5.43 Bidders, particularly those who have lost, should be debriefed in accordance with normal best procurement practice.

Timetable complications: planning permission and legislation

5.44 Many PFI projects will require planning permission. The stage at which it should be sought will depend upon the division of responsibility for obtaining it between the public sector purchaser/enabler and the supplier (see paragraph 3.22). Where, as will usually be the case, the public body bears responsibility for seeking outline planning consent, it should obtain it before issuing the ITT, to give bidders an assurance that the project will not be seriously delayed or even abandoned for planning reasons. If this is not possible, a site should at least have been identified and the public body should feel reasonably confident that planning permission will be forthcoming and bidders appraised of the situation.

5.45 Where responsibility for obtaining planning permission lies with the supplier, a formal application must necessarily await award of contract. However bidders selected to tender can and should be encouraged to make informal contact with the planning authorities as soon as possible.

5.46 At present there is a high degree of uncertainty about whether PFI projects undertaken on behalf of Crown bodies should follow the planning procedures for Crown bodies or those for private developments. Until the law is clarified, Crown bodies and their suppliers are advised to follow both routes in parallel.

5.47 Occasionally PFI projects will require legislation (for example, the Croydon Tramlink). The timing of such legislation needs careful consideration. Although bidders will want an assurance that the necessary legal powers will be available, experience with the CTRL indicates that to complete the legislative process before the procurement process can mean that some otherwise attractive bids are not compatible with the legislation. One way to avoid this problem would be to select the preferred bidder while there was still an opportunity to amend the legislation in line with the bidder's proposal.

DSS NEWCASTLE ESTATE

A project to rationalise and improve the accommodation of DSS Agencies in Newcastle. The basic requirement is to accommodate DSS staff on one or more sites, within 10 miles of Newcastle City Centre. The precise number of sites, their location and the type of accommodation, subject to meeting required standards, is for bidders to consider taking account of the commercial opportunities of the existing sites. Other features expected are:

- the winning supplier would provide at least some services relating to the new accommodation but it will be up to bidders to decide whether they wish to offer a complete facilities management service;
- design, construction, operating and some demand risk will be transferred;
- the project started as a proposal for Crown build and this original proposal is available as a public sector comparator to assess the vfm of PFI bids;
- some innovative proposals for generating additional revenue schemes through third party use of parts of the accommodation may be considered.

Contract management

5.48 There is as yet limited experience about the management of PFI contracts but it is likely that the general principles will not differ significantly from the management of other large service contracts.

5.49 Thought should be given to how the contract will be managed as soon as it has been decided to explore the PFI procurement route. If possible, the contract manager should be identified early and should be a member of the project team. If that is not possible, then another team member should be given the specific responsibility for considering the emerging contract throughout the procurement phase from the perspective of its eventual management. In particular, proposals should be developed on the following points:

- the form of the team required to manage the contract (size, skill set, roles and responsibilities, and relationships with other parts of the organisation);
- the contract change procedure;
- performance monitoring arrangements and the associated information requirements;
- mechanisms for problem solving and dispute resolution;
- contingency arrangements in the event of supplier default or other serious failure;
- preservation of the public sector body's ability to retender on termination of the original contract.

5.50 While some of these points (for example contingency plans) are equally relevant to a conventional publicly funded project, the use of PFI will tend to throw them into particularly sharp relief. Indeed, it is one of the benefits of the PFI that it brings out into the open risks that ought to be considered for any project.

5.51 As soon as the contract is awarded, the contract manager should establish close working relationships with the supplier. It is a serious error to suppose that because the private sector is responsible for providing the service as specified in the contract, the public sector purchaser has only a distant and reactive role to play. On the contrary, while not inhibiting the supplier's ability to manage the service as specified in the contract, the purchaser should be an active and intelligent customer.

5.52 PFI contracts typically last a long time and although early termination will be an option, it will be a very unsatisfactory one for both sides. The aim therefore should be to establish a relationship in which both sides are open, share information fully and work together to solve problems.

5.53 The process leading up to award of contract is likely to contain a number of important lessons. A post-project review should normally be conducted for the pre-award phases of the project as soon as possible after contract award.

CASTLE COURT, CAERPHILLY

1. An urban redevelopment scheme on a prominent 5 hectare (12 acre) site opposite Caerphilly Castle in South Wales. The area was run-down and a multiplicity of ownerships inhibited private sector investment. Following a decision by the local authorities to seek a comprehensive redevelopment of the site as part of the regeneration of the town centre, the Land Authority for Wales (LAW) became involved in commissioning a planning study and, later, in acquiring the site. LAW then chose Clive Lewis and Partners to market the site to interested developers and this culminated in Boots Properties plc acquiring the site.

2. The scheme involves a 60,000 sq ft superstore, let to Safeway, together with 90,000 sq ft of additional unit shopping. There are 30 shop units and 5 business/office units, a petrol filling station and parking for 550 cars. Boots Properties plc have invested £23 million in the project, which attracted an urban investment grant from the Welsh Office of £5.5 million. Some 400 jobs are expected to be created.

Risk transfer

3. Boots Properties have funded the scheme and are totally responsible for its design and construction including obtaining planning and other consents. They are responsible for letting the development and have taken the income risk. LAW sold the site to Boots Properties but retained the freehold until the scheme was complete.

4. Boots Properties obtain their income from rentals, and will benefit from any increase in site values.

Risks not transferred

5. LAW took on the risks of acquiring the site, undertaking certain pre-development works and agreeing a development strategy with the local authorities. This was because the private sector does not have the same powers of acquisition and the timescale involved (several years) would have been a major disincentive.

Project management process

6. Requirements were specified in terms of the price to be paid for the land and various requirements of a development brief. This covered, amongst other things, the layout of the buildings, car parking arrangements and landscaping.

7. The site was marketed for sale by private treaty with the benefit of vacant possession. Boots Properties were granted a non-assignable building licence in order that the development could commence under the control and supervision of LAW. There is a guarantor to the scheme. The freehold is to be transferred when the scheme is complete.

Chapter 6

Key Contractual Issues

6.1 This chapter examines some of the main issues that most PFI contracts will need to address. So many varied issues may arise that it is not possible to cover every aspect here. The staff of the Private Finance Panel Executive or the Treasury would be happy to advise on other issues (see list of contacts).

Contract length and transfer of assets

6.2 PFI contracts are often of longer duration than other contracts but may vary enormously in length, for example NIRS2 is 7 years, while 99 years is proposed for the Croydon Tramlink. The contract length should not be so long as to restrict competition, but this needs to be judged in the context of the type of asset and the nature of the service to which it relates. The EC procurement directives do not specifically cover the length of contracts. However, a contract considered to be over-long might possibly be open to challenge under EC competition policy (Article 85 of the Treaty of Rome) as restricting or distorting competition. In practice, this has not proved to be a difficulty but, in the unlikely event of a challenge, the Commission could be expected to examine the period necessary for the contract to work.

6.3 The advantages and disadvantages of longer or shorter contracts are fairly obvious: a longer contract enables businesses rather than project companies to be developed, gives the supplier more time to recover the cost of the investment, enabling the supplier to reduce annual charges; it gives the supplier greater depth of experience in running the business which could be a source of efficiency gain; and it makes it easier to transfer technology risk to the supplier by enabling the supplier to make more judgements about when renewal of assets and capital expenditure is incurred. On the other hand, it reduces the competitive pressure on the supplier to reduce costs and enhance quality in order not to lose the contract (although this can be overcome to a large extent by the use of performance improvement measures and incentives). Shorter contracts have the opposite balance of advantages and disadvantages.

6.4 The optimum length of contract will depend very much on circumstances. The following questions are likely to be relevant:

- does the supplier face competitive pressures to keep costs down and quality up even if the contract is not retendered? For example, a train service operator may face effective competition from road transport?
- if it does, would a longer contract provide it with more incentive to reduce costs/ improved quality, for example by renewing assets and investing in new technology, than a shorter one?
- what length of contract is required to enable the supplier to recover its investment without unacceptably high annual charges?

- would there be value for money in transferring residual value risk to the supplier, that is in having a contract which leaves the supplier with part of his investment unrecovered at the end; or would there be better value for money in a contract over the life of the assets which might result in lower unit charges?

6.5 Where the answer to the first two questions is yes, it might be advantageous to let a contract lasting longer than the life of the assets. Where the contract length will be shorter than expected asset life, the question arises of transferring the ownership of the asset from the supplier at the end of the contract. Transfer is likely to be the best solution for the asset if the following two conditions hold:

- the customer considers that it will continue to need the use of the asset. This may be, for example, in order to let a new operating contract, or in order that the asset (such as a building) can remain in public sector use;
- the supplier does not think that it will be able to find an alternative use for it. There is no presumption in favour of asset transfer.

6.6 Transfer may be to the public sector customer; or it could be to a new supplier. The latter will normally occur only where the value of the asset has not been fully recovered by the original supplier and will involve payment by the new supplier for the residual value. A method of assessing the transfer value which suits the circumstances of the project will need to be selected. Examples of methods that might be used include:

- market value where comparators are readily available;
- establishing the transfer value within the original competition, which could include an incentive on the first supplier to refresh and improve assets over the initial contract term;
- optimised deprival value based on the difference between the net present cost of providing the service by using the current asset, and the net present cost of the best alternative method of meeting the service without the benefit of using this particular asset;
- or potential suppliers could be invited to bid for the residual value as part of tendering for the new contract in cases where the future revenue streams are understood so that bidders can place a value on the cash flow.

6.7 Asset transfer may occur in the opposite direction, from public sector customer to supplier, at the start of the contract. Such transfers often take place by the sale of the asset in question to the supplier. However, it may be through the provision of a long leasehold (this is being considered, for example, for the Treasury building), providing the leasing arrangement secures value for money. Where an asset is transferred as an integral part of a PFI deal it does not need to be valued other than as part of the overall deal.

6.8 Contracts will sometimes specify a primary period plus one or more optional extension periods (both the Northern Line trains and the NIRS2 contracts have this feature). Suppliers will sometimes seek payments if the contract is not extended beyond the primary period. A termination payment of this kind (often referred to as a "balloon" payment) should be distinguished from payments for asset transfer. With a long primary contract period, a large balloon payment may not make a great deal of difference to a value for money assessment in NPV terms. However when the end of the primary contract period is reached, a large balloon payment will make it very difficult for the purchaser not to renew the contract. The effect of the balloon payment is therefore to lock-in the purchaser to the existing supplier. For that reason they should be avoided.

Payment structures

6.9 Payment structures should reflect risk transfer and should also, so far as possible, provide the supplier with an incentive to perform well.

6.10 By making no payments until the required service is being provided to an acceptable standard, the public sector purchaser will ensure that payment structures reflect the transfer of design and construction risk to the supplier. Making subsequent payments dependent upon the extent of service availability will reflect the transfer of availability risk. Payment should also be reduced to reflect any failure to meet contractually specified minimum standards of performance. Where demand risk has been transferred, wholly or in part, the level of payment should be dependent on the level of demand.

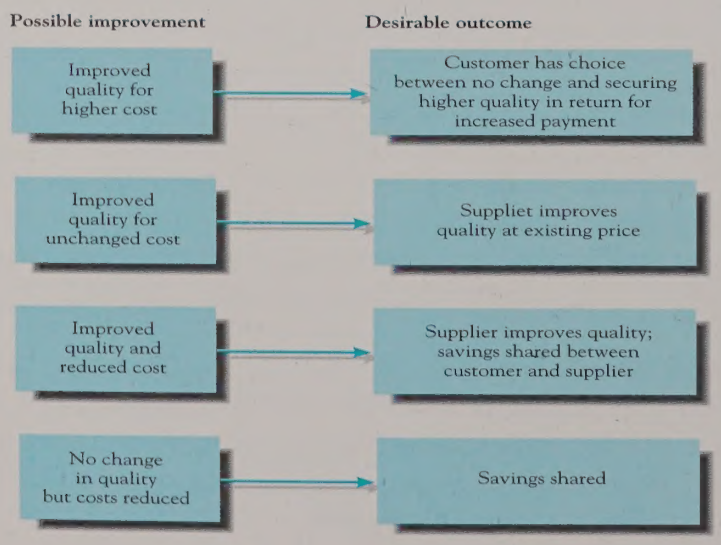
6.11 As well as incentivising suppliers not to fall below minimum standards of performance, the payment structure could also give them an incentive to improve their performance. Improved performance could take the form of lower costs or a better quality service. Where prices are fixed in relation to a fixed availability/performance standard, suppliers will have a strong incentive to achieve cost savings, as this will increase their profits, but the benefits will not accrue to the customer. One way of dealing with that is to agree a price which declines in real terms over the duration of the contract. Another approach, used for the DCMF prisons, is to have a pricing formula which allows adjustment, for example savings from technological change.

6.12 Public sector customers should also consider mechanisms for encouraging improvements in the quality of service. Two possible ways of doing this are:

- to agree with the supplier a plan for the improvement of minimum performance standards (that is those that attract the basic fee payment) over a number of years;
- to encourage the supplier to come forward with new proposals for significantly enhanced service levels as a basis for negotiating adjustments to fee levels;
- to identify performance levels above which additional profits may be shared, and incentives on the supplier to achieve those levels.

The chart illustrates the pattern of quality and cost improvements that purchasers should strive to secure.

Cost and Quality Improvements



ENGLISH PARTNERSHIPS

1. English Partnerships have adopted a flexible approach to regeneration which has led to many imaginative new partnerships with the private sector, local authorities and the voluntary sector.

Witton

2. The Witton Works adjacent to Spaghetti Junction in Birmingham is a former heavy engineering complex where much of the accommodation has been abandoned and is falling into disrepair, although parts have been rented out for a variety of industrial and storage uses.

3. English Partnerships put together a partnership with a private developer under which it would invest just under £5 million in support of the construction of 500,000 square feet of industrial floor space in two phases producing a total development value of some £22.5 million. The Agency's investment will not only create up to 1400 jobs but will also secure the decontamination of a badly polluted site, the retention and restoration of some architectural features of merit, and the removal of a major environmental blight from the local community. A linked programme of environmental enhancements to the surrounding area is in progress.

5. The basis of the Witton project is a Development Agreement between the developer and English Partnerships. An appraisal identified a gap of just under £5 million between development costs and the market value of the completed development.

6. English Partnerships agreed to invest this sum on the basis of quarterly payments pro-rata to work completed on site. Any savings on development costs would be shared 50/50 and time limits were set for the completion of each of the two phases with appropriate penalty clauses for repayment in default. The Agreement included arrangements for a 50/50 sharing of any value in completed phases beyond that identified in the course of the project appraisal.

7. Value for money was measured principally by extremely close examination of the basis of cost and value for the development underpinned by the sharing of any savings and value increases as well as by calculating the cost per net new job. The outputs of derelict land reclaimed, industrial floor space created and environmental enhancement achieved were also taken into account.

8. Clearly, by allowing for investment up-front during the development process English Partnerships are sharing some of the development risk but the full commercial risk which the private sector would normally expect to bear on a site with no abnormal costs is left with the developer. The sharing of any value increases above the appraisal figure and of any cost savings achieved on the job gives the Agency a potential return on its share of the risk as well as providing the developer with a strong incentive to maximise value and minimise cost.

Barking Reach

9. A second example is the first phase of the creation of a new urban village in Barking Reach, east London. English Partnerships are investing £8 million and its partners will be Bellway Homes, the London Borough of Barking and Dagenham, and National Power. The total cost of the first phase will be £32 million to develop 20 acres and build 473 new homes. Further phases will see the development of the rest of the 495 acres to produce up to 5500 new homes.

10. As part of the strategy for developing the Thames Gateway (formerly East Thames Corridor) Barking Reach was identified as a pivotal site which could make a major contribution towards identified housing need over the next ten years. The site suffers from abnormal development costs, particularly from site contamination, the need to provide basic services and place existing overhead electricity cables underground.

11. Value for money from the Agency's contribution to the partnership has been ensured by a rigorous appraisal procedure. The Agency's phased contribution is directly linked to certified expenditure for work which has been competitively tendered. This ensures that payments are not made in advance of need. English Partnerships' total contribution is capped at a level which represents the Agency's view of the share of the risk it should be bearing in order to compensate the developer for the abnormalities of the site. National Power, who are the major landowners, and the London Borough of Barking and Dagenham are contributing land at a market value based on its use for open storage. These arrangements leave the remaining commercial risk to be borne by Bellway Homes.

12. Bellway Homes is providing the commercial funding and will take the receipts from the house sales. There is, however, provision in the partnership agreement for a return to English Partnerships and the landowners if income from house sales exceeds an agreed value. There is also provision in the agreement that, as values rise in later phases and further investment from English Partnerships is no longer required the Agency will receive a percentage of the net proceeds from the sale of any land to third parties.

6.13 Suppliers may seek to index payments to take account of inflation. Where design and construction risk has been transferred to the supplier, there should be no index payments until the service is available. As index payments would relate to payment for the service, the index should be a general and broad measure of inflation published by the Government. The RPI and GDP deflator are both published regularly. Public bodies should avoid using indices which do not fall into this category. Where feasible they should try to aim for an index minus x formula, to reflect efficiency improvements. Indices will, however, tend to build in price increases and should be used with great care.

Contract termination

6.14 Early termination of the contract may occur on one of several grounds including: default (by either party); voluntary (unilateral) termination; and force majeure.

Supplier default

6.15 The contract should specify the conditions under which supplier default may occur and the consequences of default. Normally the conditions of default will include a failure to meet contractual obligations, in particular failure to meet specified performance levels. This may be a single very serious breach, or it may be a continuing, non-remedied failure.

6.16 Where failure to perform is the problem, the public sector customer should normally have the option of giving the supplier more time to improve performance with reduced payments until such improvement is achieved. If the supplier continues to perform inadequately, its financier will be likely to have step-in rights which entitle it to find an alternative operator to run the service. So far as the customer is concerned, this is a reorganisation within the group providing it with a service. It now deals with a new operator but its contractual rights and obligations are otherwise unchanged. The customer should have the right to veto the use of a new operator if it is not satisfied that it could provide the required service (see "assignment", paragraph 6.31).

6.17 If the financier is unable to find a satisfactory alternative operator or if there are no step-in rights, the contract should provide for termination. It needs to address two main issues:

- what happens to the assets?
- what, if any, compensation payments are made?

6.18 As the cases described in Chapter 4 indicate, there is a wide variety of practice. For the DCMF prisons, the assets always revert to the Prison Service. For Northern Line trains, LUL has the option of whether to retain or hand back the asset. In each case, if the asset is transferred in event of supplier default, the public sector customer will not pay full recompense, and in some cases may pay none.

Supplier insolvency

6.19 It is normal for contracts to provide that the customer would have the right to terminate the contract in the event of the supplier becoming, or appearing likely to become, insolvent - although, in practice, the supplier or its financier may seek consent for an assignment to another supplier (see paragraph 6.31). The future of the assets in the event of termination needs to be addressed as above.

Public sector default

6.20 It should not normally be necessary to provide in the contract for public sector default. This would occur only if the customer failed to meet its contractual obligations, other than by reason of voluntary termination of the contract or supplier default. In the event that the customer agrees to include a reference to public sector default in the contract, the main issue will be the compensation to which the supplier would be entitled. The compensation payable or the method of calculating it should be defined in the contract. It will be dependent on the extent to which the supplier could exploit its asset elsewhere.

Public sector change of status

6.21 Suppliers or their financiers may be concerned that the public sector body with whom they are dealing could be privatised, wound up or otherwise undergo a major change of status. Where the private sector seeks assurances about continuity of a contracting public sector entity, or other issues relating to a change of status of the public sector body, that body should seek advice from its sponsoring government department. The sponsor should consult the Treasury if a novel or potentially contentious issue arises. (See also voluntary termination below).

Voluntary Termination

6.22 Voluntary termination occurs when one or other side takes an active decision not to proceed with the contract other than as a result of default or force majeure. The contract should state that voluntary termination would only be available to the public sector; or should make it clear that where voluntary termination is made by the supplier, the same conditions would apply as under a supplier default (in practice, its consequences would be identical with supplier default). Voluntary termination arises for the public sector because of a possibility of a change in Government policy. In circumstances where Government exercises voluntary termination of the contract, compensation will be paid in accordance with the procedure set out in the contract. It is better to deal with the issue of voluntary termination explicitly in the contract than to leave the consequences to negotiation if and when the event occurs.

6.23 In general, compensation to the supplier for voluntary termination by the public sector customer should depend on the extent to which the supplier can exploit its asset elsewhere. Where the PFI project involves assets for which there is little or no market, the supplier's interest may need to be bought out entirely. Where the public sector body will wish to retain the asset after terminating the contract, the method of calculating the price to be paid for it should be set out.

Supplier equity and control

6.24 The contract should normally reserve the customer's right to terminate the contract in the event of a change in the controlling interest in the supplier. It will normally be appropriate to give undertakings that this right will not be unreasonably exercised. Indeed, it would often be advantageous to the project for the equity holder in a supplier, or a consortium formed for the purpose of delivering the service, to sell that equity to others; and the contract should not be so worded as to discourage this possibility.

Force Majeure

6.25 Force majeure normally refers to events like war, civil disorder and nuclear contamination but, in exceptional circumstances the term may be extended to cover a wider range of events. The contract needs to establish in what circumstances force majeure events will lead to termination and what the consequences will be in terms of ownership of the asset and payment of compensation. Where termination is not appropriate, the contract needs to address how the additional costs arising out of the force majeure event are to be met and whether there are any other consequences such as an extension of the contract period.

Change control and dispute resolution

6.26 The contract will need to be able to deal with unforeseen changes in circumstances. On the customer side, these typically take the form of changes in output requirements. It will normally be best to include explicit change control procedures in the contract. Contracts should also specify a procedure for settling disputes, either about changes or about interpretation of existing provisions.

6.27 There are four main categories of dispute resolution: negotiation; alternative dispute resolution procedures (ADR); arbitration; and litigation. Negotiation should always be the first step and litigation a last resort to be avoided if at all possible. ADR includes mediation, judicial appraisal and adjudication. In general, contracts should identify one or more ADR procedures to be followed and should specify how the mediator/adjudicator etc. will be appointed. Detailed guidance on disputes resolution is given in CUP guidance No.50.

Indemnities and insurance

6.28 Any request for an indemnity can only be considered in the context of decisions on risk transfer. Although each case will need to be looked at on its merits, the broad approach is clear.

6.29 Where risk has been transferred to the supplier, there should be no indemnities by the public sector customer. So, for example, where construction risk is transferred in full, the supplier should not be indemnified against adverse ground conditions. It is for the supplier to take out commercial insurance to cover its risk as it thinks fit or as the contract requires.

6.30 Where risk is shared, public sector indemnities may be appropriate. For example if planning permission risk is shared with the public sector body having responsibility for obtaining outline planning permission then, in the event of such permission being refused, it would be appropriate for the public sector body to refund nugatory expenditure undertaken by the supplier, but only that incurred after the award of the contract.

Other issues

6.31 **Assignment.** Public sector customers should ensure that suppliers cannot assign any part of the contract to a third party without public sector agreement. (The need for consent should apply not only to novation of obligations - where the law requires it - but also to assignment of any rights of the supplier; it is desirable that obligations and rights transfer together to preserve an appropriate incentive for the supplier to perform.) It may be necessary to give undertakings that such agreement will not be unreasonably withheld and the public sector should recognise that assignment may be essential to initial finance of the capital asset.

6.32 The contract should also make provision for assignment to the public sector body of such sub-contracts that may need to be transferred in the event of termination of the main contract. It will also usually be appropriate to enter into specific agreements with key sub-suppliers to ensure that the sub-contract does not itself terminate if the main contract terminates.

UNIVERSITY OF GREENWICH (RESIDENTIAL ACCOMMODATION)

1. A project to provide new residential accommodation for over 600 students. Total initial capital costs are in the region of £11 million. The University signed a contract with Wimpey to build and then operate the accommodation to agreed performance standards for 30 years. All the finance for the investment has been raised by the consortium.

2. The consortium recovers its capital and makes its profit from the rents for the use of the rooms and by the use of the accommodation commercially out of term time - for example, for conferences. The project is due for completion by September 1996.

Risk transfer

3. The risks transferred to the private sector by this deal are:

- construction costs and construction time - if these overrun estimates, then the consortium bears the cost or pays to accommodate the students elsewhere;
- facilities management costs - if the consortium cannot deliver the agreed level of facilities management service at the cost specified, then it bears the extra costs;
- replacement costs - if the costs of providing or replacing the equipment to the appropriate standard exceed expectations, then the consortium bears the cost;
- the risk associated with out of term time use - to make its profit, the consortium needs additional out of term income. It bears the entire risk of not doing so (and pays the University a charge for the use of the facility).

Risk not transferred

4. The main risk retained by the University is the occupancy guarantee - the University will pay for 97 per cent of the rooms during term time even if they are not filled. The University believes this is a risk they are in a good position to manage.

6.33 **Intellectual property rights.** The contract should specify ownership of IPR. Normally each party will retain the rights to the intellectual property which it has developed. The treatment of IPR in the event of termination should be specified where relevant. The contract must provide for the intellectual property to be available to Government in the event of default or for the retendering process. For example, in the event of supplier default, the public sector customer may need to arrange for the service to be provided in another way and this could require the new provider to have access to the original supplier's intellectual property.

6.34 **Service levels/performance standards.** The contract must specify clearly what service levels or performance standards the supplier is required to meet and the consequences of failing to do so. There will frequently be a tension between the customer's wish to have a comprehensive set of performance standards and the requirement for effective monitoring arrangements. There is no point in prescribing performance standards that in practice will be too difficult or too expensive to monitor.

Annex A

Joint Ventures

Joint ventures are projects to which both public and private sectors contribute and whose returns they share. In many cases the returns for the private sector will be wider social benefits that cannot be captured in financial returns, but they could also be service benefits (for example from a shared facility) or, occasionally, direct financial returns.

A joint venture can comprise:

- a single corporate entity in which the Government has a non-controlling equity stake;
- an arrangement involving separate organisations, including public sector bodies, which act jointly or severally;
- a project which is taken forward by the private sector with Government contributing grants, loans, existing assets or ancillary or associated works.

Effective control of a joint venture must rest with the private sector. If it does not the project will be subject to normal public expenditure controls.

The assessment of the value for money of the public sector contribution to the joint venture, risk transfer and the selection of private sector partners using competition are dealt with in the main body of the document. In addition the following technical issues might arise.

(i) Effective control of an incorporated joint venture

The treatment of an incorporated joint venture in the national accounts will be determined by the effective balance of control. A body controlled by the public sector will itself be treated as in the public sector with the normal implications for public expenditure control and scoring. A majority of board members appointed by the public sector or a majority of voting shares held by public sector bodies would normally indicate public sector control. But effective public sector control could also be achieved by other means, for example, control over pricing, other partners not operating in concert, or control via conditions placed on funding. In cases of doubt the Treasury should be consulted.

(ii) Financial assessment of the project

The aim is to obtain an initial assessment of the likely net present value of the financial returns to the project that a private sector participant would require. Information on this might be obtained from possible participants in preliminary discussions in advance of the competition. The likely outcome is a range of figures, depending on assumptions about revenues, costs and private sector discount rates. This range should be used to set the public sector contribution at a realistic level.

(iii) Size of the public contribution

The appropriate size of the public sector contribution should be closely examined in the appraisal and clearly justified in terms of objectives and expected benefits. The Government's aim, in making a contribution, is to provide the appropriate size of public sector contribution that ensures that the project has a reasonable chance of success. In practice this means that the public sector contribution has to be at a level that makes the project attractive to the private sector in terms of the level of returns it is likely to expect.

(iv) Definition of the public sector contribution

This should include all contributions from all public sector bodies willing to participate in the project, including (for example) local authorities. It should include contributions from these bodies drawn from European Community sources, such as the European Regional Development Fund (ERDF). But it would not include finance from European sources provided direct to the UK private sector, as is often the case with loans from the European Investment Bank (EIB). The Government's contribution can take a number of forms, for example grants, loans, equity, transfer of assets, ancillary or associated works or some combination of these.

(v) Transfers of assets

Sometimes joint ventures are proposed where the public sector owns an asset (often land) which may form part of its contribution to the joint venture if transferred at less than market value. Unless the transfer of assets in this way is covered by legislation, certain procedures regarding propriety will need to be observed (see *Government Accounting*, Chapter 32).

(vi) The assessment of wider benefits

Every attempt should be made to quantify and value the wider benefits but inevitably it will be difficult to do this in some cases, for example environmental effects. Where quantification is not possible, all significant wider benefits should be clearly listed.

(vii) Discount rates

Detailed guidance on discount rates is provided in Annexes E and G of the *Green Book*. In the case of joint ventures:

- an assessment of the minimum commercial return (or private sector discount rate) is required, in order to calculate the net present value of the private sector financial returns and so assess the viability of the project. Initially this will be an estimate of a figure (or range of figures) that the competition is likely to produce. Rules of thumb from established programmes are often useful guides;
- the cost-effectiveness of alternative options for the public sector contribution (for example, comparing a minority equity stake with a grant) should be appraised using a discount rate in real terms of 6 per cent (reflecting time preference and the cost to the taxpayer, see paragraph 20 of Annex E to the *Green Book*);
- for comparison with the estimated size of the minimum public sector contribution, the present value of the wider social benefits (or the direct service benefits) should be calculated using her 6 per cent or 8 per cent depending on the context (see Annex G to the *Green Book*).

Annex B

The Accounting Treatment of PFI Projects

1. This Annex elaborates on the accounting treatment of PFI projects, particularly those where the Government is the sole or main purchaser of services provided by a supplier. As Chapter 3 explains, transactions that are in substance only borrowing, such as finance leases, will normally be capitalised in commercial accounts in both public and private sectors. Good PFI projects, with VFM benefits, involve transfer of risk to the private sector.

2. The relevant accounting standard for determining whether an asset should be capitalised on the balance sheet is **FRS5**, whose underlying principle is that the substance of an entity's transactions should be reported in its financial statements. Judgments about the underlying substance are likely to be strongly influenced by the degree of risk transfer.

3. The detailed treatment of leases and hire purchase contracts is governed by the accounting standard **SSAP21**. This defines a finance lease as a lease where substantially all the risks and rewards of an asset reside with the lessee. It includes some quantitative guidance, in particular that a finance lease is normally presumed to exist if the minimum lease payments exceed 90 per cent of the fair value of the leased asset.

4. The accounting profession introduced **FRS5** after **SSAP21** to ensure that financial statements reflect the economic substance of transactions, and not simply a mechanistic application of numerical thresholds. **FRS5** did not replace **SSAP21**. It explains the relationship between the two standards as follows:

   "In general, **SSAP21** contains the more specific provisions governing accounting for stand alone leases that fall wholly within its parameters, although the general principles will also be relevant in ensuring that leases are classified as finance or operating leases in accordance with their substance."

5. The general principles of **FRS5** are:

   (a) an entity has an asset if it is exposed to the risks inherent in the benefits produced by that asset, taking into account the likelihood of those risks having a commercial effect in practice;

   (b) where one party receives a lenders return but no more, this indicates that the substance of the transaction is that of a financing; and

   (c) where a transaction incorporates options, guarantees or conditional provisions, their commercial effect should be assessed in the context of all aspects of the transaction.

6. Where the investment made by an asset constructor/operator is subject to a significant risk of not being recovered in full, such a transaction is likely to be treated as off balance sheet. A combination of technological/obsolescence risk and performance risk, together with residual value and demand risks, where appropriate in the context of the asset and service to be provided, should secure such a treatment.

7. Arrangements which are treated as off balance sheet will result in the public sector, in substance, being the purchaser of a **service**. A transaction that, to all intents and purposes, is a fixed price procurement, with outsourced maintenance, on a cost plus basis, would be regarded as on balance sheet.

8. The wider the scope of the project to transfer responsibilities for asset operation, the greater the potential for the private sector to manage a broader range of risks, and hence the more likely the arrangements will be treated as off balance sheet.

Annex C

EC Procurement Rules

1. This annex provides a brief summary of EC procurement rules and their application to PFI projects. For more detailed information the note by the Treasury entitled "Introduction to the EC Procurement Rules" (CUP Guidance No 51) should be consulted. It includes a list of the UK Regulations implementing the EC procurement directives. Copies of this note can be obtained from the Treasury's public enquiry unit on 0171 270 4558).

To whom do the rules apply?

2. The EC Procurement Rules and the Regulations which implement them in the UK apply to the following two groups:

   - Public authorities. In the UK this includes government departments and agencies, non-departmental public bodies, the NHS and local authorities;
   - Utilities, ie certain operators in the water, energy, transport and telecommunications sectors, whether publicly or privately owned.

3. In the main, this annex applies to public authorities. There may be small differences in the rules for utilities.

To what types of procurement do the rules apply?

4. The rules apply to the following types of procurement when their value is above the threshold levels (it is unlikely that many PFI projects will be below threshold levels):

   - works contracts: contracts for the carrying out of civil engineering or building works or under which such facilities are provided to meet specific user requirements;
   - works concession contracts: works contracts under which the contractor is given the right to exploit the works, for example as for tolled river crossings;
   - subsidised works contracts: works contracts awarded by a body other than a public authority for certain types of works where a public authority contributes more than half the cost;
   - supply contracts: contracts for the purchase or hire of goods and for any siting or installation of those goods;
   - service contracts: contracts under which the purchaser engages a contractor to provide services. There are two categories: Part A to which the regulations apply in full; and Part B

which are only subject to the requirements in the regulations applying to technical specifications and post-award information. PFI contracts are likely to be covered by Part A. The leasing of equipment with an operator counts as a service;

- design contests: procedures for obtaining plans or designs which may lead to the award of a service contract.

5. Service concession contracts (contracts under which a purchaser engages a person to provide services and gives him the right to exploit the provision of these services to the public) are excluded from EC procurement rules.

What types of procurement procedure are there?

6. The rules specify three types of award procedure:

- the **open procedure** under which all interested persons may tender for the contract. It is extremely unlikely that the use of the open procedure would ever be appropriate for a PFI project;
- the **restricted procedure** under which only selected persons may submit tenders for the contract;
- the **negotiated procedure** under which a purchaser may negotiate the terms of the contract with those persons selected by it. As a general rule there must be a call for competition. But in certain specified cases the negotiated procedure may be used without a call for competition.

7. Under the restricted procedure and the negotiated procedure with a call for competition there must be a sufficient number of participants to ensure genuine competition. Normally, the minimum will be three but where, under the restricted procedure, a public authority specifies the range in which the number of participants will fall, the minimum will be five.

When can the negotiated procedure be used?

8. Utilities have a free choice between the open, restricted and negotiated procedures (provided the latter includes a call for competition). Public authorities have a free choice between the open and restricted procedures but may only use the negotiated procedure, with a call for competition, in limited circumstances. For example:

- **Works and Services:** exceptionally, when the nature of the works or services to be provided, or the risks involved, are such as not to permit overall pricing;
- **Services:** where the nature of the services to be provided is such that specifications cannot be drawn up with sufficient precision to permit the award of the contract using the open or restricted procedure.

But there are no equivalent provisions for supplies.

9. It is very likely that most PFI projects will meet the conditions required for the use of the negotiated procedure with a call for competition, at least until such time as the use of private finance has become well embedded and new contracts begin to follow a pattern already laid down by previous ones. The principle difference between the restricted procedure and the negotiated procedure is the

limitation which the former imposes on the extent to which negotiation with the participants is permissible. Negotiations with bidders is normally a critical part of a PFI project and public bodies are strongly recommended to use the negotiated procedure whenever the conditions are met.

When is competition not necessary?

10. The negotiated procedure without a call for competition may be used when for technical or artistic reasons, or for reasons connected with the protection of exclusive rights, the contract can only be carried out by a particular person. This applies to works, supply and service contracts.

11. Other circumstances in which competition is not required include (the list is not exhaustive):

- works concession contracts: requirements must be advertised in the OJEC and expressions of interest cannot be rejected on grounds of nationality, but there is no requirement for a competition;
- contracts for Part B services;
- where the rules of a design contest require a service contract to be awarded to the successful contestant;
- goods manufactured for certain research, experiment, study or development purposes.

12. Where a competition is not required under EC rules, it may nevertheless be advisable for value for money reasons (see paragraphs 5.17-5.20 of main text for an indication of the limited circumstances in which competition is not necessary).

What rules apply to the use of the negotiated procedure?

13. The rules which apply specifically to the use of the negotiated procedure with a call for competition include:

- the requirement for contract notices to be published in the OJEC;
- the requirement for minimum timescales to be allowed for responses: not less than 37 days, or exceptionally where that would be rendered impracticable for reasons of urgency, not less than 15 days;
- the requirement to base the selection of providers to negotiate the contract on the criteria set out in the Regulations and, in particular, an explicit requirement of non-discrimination on the grounds of nationality or the state in which the provider is established;
- the requirement for not less than 3 providers to be selected to negotiate the contract provided there is a sufficient number of suitable providers.

14. Under the competitive negotiated procedure, bidders selected to negotiate the contract will normally be invited by the purchaser to submit tenders. These will provide a basis for negotiations. However, there is no mandatory requirement for tenders and the purchaser could, if it wished, proceed direct to negotiation. It is also free to conduct pre-tender negotiations.

15. When undertaking negotiations, the purchaser must observe the following principles:

- transparency;
- objectivity;
- non-discrimination;
- equality of treatment;
- measurability.

In particular, great care must be taken to ensure that all potential contractors are treated fairly and that competition is not distorted as a result of a particular contractor being able to gain an advantage which is not available to others.

Are there limitations on length of contract?

16. Contract length is not specifically covered in the regulations. A contract considered to be over-long might possibly be open to a challenge under EC competition policy (article 85 of the Treaty of Rome) as restricting or distorting competition. In practice, this has not proved to be a difficulty. However, in the unlikely event of a challenge, the European Commission can be expected to examine the length of contracts to consider what period is necessary for the contract to be workable. This could be expected to vary from contract to contract.

List of Abbreviations

BOO:	Build, Own and Operate
BOOT:	Build, Own, Operate and Transfer
CA:	Contributions Agency (a DSS Executive Agency)
CCT:	Compulsory Competitive Tendering
CCTA:	The Government Centre for Information Systems (part of the Office of Public Service)
CTRL:	Channel Tunnel Rail Link
CUP:	Central Unit on Procurement (part of HM Treasury)
DBFO:	Design, Build, Finance and Operate
DCMF:	Design, Construct, Manage and Finance
DOT:	Department of Transport
DSS:	Department of Social Security
EC:	European Community
EFL:	External Financing Limit
FRS5:	Financial Reporting Standard 5
Green Book:	Economic Appraisal in Central Government: A Technical Guide for Government Departments
IS/IT	Information Systems/Information Technology
ITT	Invitation to tender
LUL:	London Underground Limited
NHS:	National Health Service
NIRS2:	National Insurance Recording System 2
NPV:	Net Present Value
OJEC:	Official Journal of the EC
PES:	Public Expenditure Survey
PFI:	Private Finance Initiative
SSAP 21:	Statement of Standard Accounting 21
TUPE:	Transfer of Undertakings (Protection of Employment) Regulations
VFM:	Value for Money

Other Relevant Publications

CCTA (see also Private Finance Panel):

- IS Guide A2: Strategic Planning for Information Systems
- IS Guide B4: Appraising Investment in Information Systems
- Market Testing Briefing: IS/IT at Risk *(March 1994)*
- Other Market Testing/Outsourcing Guidance
- The Total Acquisition Process Services Guide *(January 1995)*;

Department for Education and Employment:

- Education Means Business - Private Finance in Education *(1994)*

Department of the Environment:

- New Private Finance Rules for Local Authorities *(March and October 1995)*;
- Private Finance for Housing - A Guide for Local Authorities *(January 1995)*
- Working Together - Private Finance and Public Money *(June 1993)*.

Department of Transport:

- Building Tomorrow's Transport Network *(November 1994)*

Higher Education Funding Council for England:

- Private Investment in Higher Education.

Ministry of Defence:

- Private Finance Initiative: - Guidelines for the MOD *(1995)*

NHS Executive:

- Guidance for Financial Institutions and others trading with NHS Trusts *(August 1993, ref: FDL 93/61)*
- Capital Investment Manual, Private Finance Guide *(HMSO, 1994)*
- Private Finance and Capital Investment Projects *(March 1995, ref: HSG (95)15)*

Private Finance Panel and CCTA:

- The Private Finance Initiative and Government IS/IT *(December 1994)*

- The Private Finance Initiative and Government IS/IT: Risk *(March 1995)*

- The Private Finance Initiative and Government IS/IT: Report on the NIRS2 project *(October 1995)*

Private Finance Panel and Property Holdings:

- Private Finance Initiative in Government Accommodation *(HMSO October 1995)*

Scottish Office:

- Private Finance Partnership in Scotland *(March 1995)*

- Scottish Water and Sewerage Services: An Outline Structure for Build, Own, Operate Schemes *(September 1994)*

HM Treasury*:

- Breaking New Ground *(November 1993)*

- CUP guidances, especially:

  - No 40 - The Competitive Tendering Process
  - No 42 - Contracting for the Provision of Services
  - No 47 - Contract Management
  - No 48 - Bonds and Guarantees
  - No 50 - Disputes resolution
  - No 51 - Introduction to the EC Procurement Rules

- Economic Appraisal in Central Government: A Technical Guide for Government Departments *(HMSO; April 1991)*

- Risk Management Guidance Note *(June 1994)*

- Setting New Standards: A strategy for Government procurement Cm 2830 *(HMSO: May 1995)*

Welsh Office:

- Private Finance and Public Projects in Wales *1995*

Other:

- Financial Reporting Standard 5: Reporting the Substance of Transactions *(Accounting Standards Board: April 1994)*

** NB This publication replaces previous Treasury private finance guidance notes.*

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